FEDERAL RESPONSE TO FINANCIAL EMERGENCIES OF CITIES

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON GOVERNMENT OPERATIONS HOUSE OF REPRESENTATIVES

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CONTENTS

FEDERAL RESPONSE TO FINANCIAL EMERGENCIES OF CITIES

MONDAY, JUNE 23, 1975

HOUSE OF REPRESENTATIVES,
COMMERCE, CONSUMER,
AND MONETARY AFFAIRS SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:45 a.m., in room 2154, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Robert F. Drinan, Elliott H. Levitas, David W. Evans, Andrew Maguire, Garry Brown, and Willis D. Gradison, Jr.

Also present: Peter S. Barash, staff director; Wanda J. Reif, counsel; Robert H. Dugger, economist; Doris Faye Taylor, clerk; and Lawrence T. Graham, minority professional staff, Committee on Government Operations.

OPENING STATEMENT OF CHAIRMAN ROSENTHAL

Mr. ROSENTHAL. The subcommittee will come to order.

Today, the Commerce, Consumer, and Monetary Affairs Subcommittee begins hearings into the operations of the Federal Government as they relate to the financial emergencies facing an increasing number of America's urban communities.

In a July 1973 report entitled, "City Financial Emergencies," the Advisory Commission on Intergovernmental Relations identified 30 cities with serious fiscal problems, a number that is undoubtedly much larger today given the state of our national economy.

The Commission concluded that "An incredible and seemingly insoluble array of financial difficulties confront urban governments in America today." They continued:

> It is in cities that are found outdated capital facilities, demands for increased services for minorities and poor persons, wornout equipment, the inability to increase the tax base, the inability to exceed debt ceilings, citizen tax rebellions, competition with other governmental units for state and local revenue sources and a general inability to make the revenue sources stretch to fit the expenditures mandated by the state and demanded by the people.

The issues to be examined by this subcommittee in Washington and elsewhere include the following:

What is the proper role of the Federal Government with respect to the financial emergencies of our urban communities? To what extent do Federal monetary and fiscal policies contribute to the money crises of our cities? Is Federal tax exemption for State and local securities, which in 1976 will deprive the U.S. Treasury of $3.5 billion in revenues from corporations and $1.3 billion from individuals, the most efficient method of financing municipal debt?

Are the examination and audit policies, practices, and procedures of Federal banking regulatory agencies efficient in terms of identifying the ways in which the loan and investment activities of banks affect the fiscal condition of our cities? Are the operations of the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation attuned to the needs of the cities and the complex interrelationships between the cities and the financial community?

All of these questions and others underlie the basic issue of whether operations of the Federal Government are sufficiently responsive to municipalities in fiscal difficulty.

It is clear that the Federal Government is sensitive to the fiscal distress of our private corporations. For example, the Federal Deposit Insurance Corporation, which comes to the aid of failing or failed banks, assisted the National Bank of San Diego and Franklin National Bank in the amount of $4 billion. The U.S. Department of Agriculture recently deferred for 1 year $342 million owed the Treasury by a subsidiary of Cargill Grain Co. The Overseas Private Investment Corporation, the Emergency Loan Guarantee Corporation—which bailed out Lockheed—the Commerce Department and other Federal agencies provide billions of dollars in financial assistance each year to the private sector.

In contrast to this ambitious Federal effort, is the absence of a responsible Federal program of emergency financial assistance to the cities.

We are honored this morning that this series of hearings commences with the testimony of the mayor of the No. 1 city of our Nation, the city of New York.

STATEMENT OF MAYOR ABRAHAM D. BEAME, NEW YORK CITY, N.Y.

Mr. BEAME. Chairman Rosenthal, Congressman Drinan, Congressman Levitas, Congressman Gradison, Congressman Brown, I want to thank you for this opportunity to speak about the problems of State and local governments which must borrow funds in the capital market, especially on a short-term basis.

The financial problems of the city of New York have become the subject of worldwide concern. Despite the naive and provincial observations made by representatives of the administration in Washington, New York is very much a factor in national and international economics—and its failures and successes have reverberations that impact on every city in the Nation, and capitals throughout the world.

During the perilous weeks just past, when the city hovered on the brink of default because it had been denied access to credit, the Wall Street Journal and other publications reported that the dollar was fluctuating on the international money market because of New York City's fiscal situation; and, throughout this Nation, tax-free obligations were having a rough time in the marketplace.

No government, no business, no institution can function without access to credit in our economy. The city of New York is hardly an exception. And, even though it has annual revenues in the order of $12 billion, by the very nature of how the city operates, it must have a steady cash flow to pay salaries, redeem debts, and pay bills.

If this cash flow is choked off, for whatever reason, it is possible that the city could not meet its obligations on time, although there would be no prospect of its not meeting its obligations in full.

Contrary to the Treasury Secretary's assertion, a default by the city of New York, the second largest governmental entity in the Nation, would have catastrophic impact.

It is my hope that this committee will shed light on the circumstances that can bring about this kind of fiscal crisis, and to recommend protections which can be afforded to municipalities—large and small—against the vagaries of the economic marketplace, or of those forces that shape that marketplace.

It is not my purpose to come before this committee and offer some grand conspiratorial design as the reason for the current fiscal woes of our city. I have been around too long in public service to be the advocate of a Devil theory.

I do recognize, however, that very often forces and actions coalesce—sometimes coincidentally and sometimes ideologically—to create new sets of pressures for change. In the recent case of New York City, I believe both coincidence and ideology played a role.

It would be difficult if not impossible to trace every factor contributing to the current cash crisis, but I would like to cite some of them which may be of particular interest to this committee.

(1) Of primary consideration is the disastrous state of the national economy which stems directly from Federal policies or lack of them. The runaway inflation and crushing recession is especially felt in major urban areas. This resulted in higher governmental operating costs and reduction of tax revenues. In my judgment, if these dire national conditions did not exist, the city would not have a cash problem today.

The energy crisis also had devastating and disproportionate effects upon the city of New York which is largely dependent upon Arab imports for heating fuels. The consequent cost of energy for government operations and the delinquency on real property tax collections has cost the city many millions of dollars.

Last September, I publicly called attention to the alarming increases in city operating costs. They were brought about by higher interest rates which would cause more than $100 million in added deficits, and higher energy and welfare costs totaling about $90 million more than anticipated. Similarly, the recession cut $150 million from our anticipated revenues.

(2) The growth of the New York City budget in other-than-housekeeping functions, primarily those mandated by State and Federal law, is another key factor in our cash crisis. In the past 10 years, the personnel carried by the city for housekeeping functions (police, fire, sanitation, water supply, sewers, and so forth) decreased by 4 percent. Those employed in Federal- and State-aided programs increased 37 percent. Borrowing against the anticipation of these Federal and State revenues has, logically, increased as well. In effect, the more aid we are promised, the more we must borrow to maintain a cash flow. The failure to receive these aid payments in a timely fashion has seriously contributed to the need for additional borrowing.

(3) There has been a general erosion of the tax-exempt bond and note market. For example, the proliferation of a wide variety of tax shelters has wooed the investing institutions away from tax-exempt municipal obligations. The tight money policy has been another reason.

I recognize that the large amount of New York City short-term obligations on the market was an important ingredient in the current crisis.

Obviously, the tight money and cash shortage conditions hit New York City hardest.

(4) The "disclosure" requirement set forth in the Securities and Exchange Act is now being interpreted to preclude all those who issue or sell securities, including municipalities, from misstatements of fact or omissions of pertinent information. This has created an atmosphere of skittishness among the financial houses. It was especially so because of recent bondholders' suits against the underwriters, which alleged that they had floated "moral obligation" bonds for the State financial difficulties.

The market for city securities, which are full faith and credit obligations, nevertheless was affected by the UDC default, and our securities were penalized, for no intrinsic reasons, in terms of higher rates and an unwarranted stigma.

(5) Inasmuch as New York is the country's communications capital, its local government receives national news coverage. In Des Moines and Dallas, the saga of our budget is probably as well known as the latest developments in their own city halls.

We find that the Nation's investing market is extremely sensitive to media reports about the city.

For example, in apparent response to sensational stories relating to the city comptroller's office last summer, the interest rate of city notes skyrocketed almost 20 percent on July 17. For the first time, these tax-exempt obligations had rates higher than the Federal taxable bills.

In another example, several hours before the underwriting banks submitted their bids at 11 a.m. on November 4, 1974, the New York Times ran an editorial on budget balancing problems which, unfortunately, was headed "Near-Bankrupt City." The editorial went on to use the word "bankruptcy" which has special impact upon individuals and institutions who invest money in the city's securities.

On that day, our interest rates rose more than 60 points, and again were higher than yields of comparable Treasury bills.

While it is clear that a city and its finances are fair game for editorial comment, there is little doubt that such comments have an effect on the market.

(6) Finally, one of the major reasons for the cash crisis which has been most publicized, is the budget gap, an annual fact of life. On April 3 of this year, Moody's, recognizing this fact, nevertheless reaffirmed its faith in New York City bonds by maintaining its "A" rating with the comment:

> For half a century now, it has been widely known that New York City has a revenue problem, a systemic difficulty in raising additional revenues to keep up with expanding needs.

Moody's noted that our city's budget balancing problems "are aggravated by business recession and that liquidity is impaired in some proportion to declines in economic activity. But New York City's debt is secured by much more than its current liquidity position."

In reaffirming an "A" rating for our bonds, Moody's came directly to the point involved in any evaluation of New York City's credit-worthiness: "A strong backing of the city's obligations and the city's unique position in the American economy provides strong assurance to the creditor," and added that New York City's "securities have become a good buy for investors seeking yield and willing to withstand adverse and often irrelevant publicity."

Inasmuch as the city is committed to have a balanced budget, it has no choice—as has been demonstrated in the past weeks—either to cut its costs, or find new revenues.

In the case of this 1975–76 fiscal year budget, I had pledged early and often that I would no longer permit budget balancing by any means except by recurring revenues.

I have long acknowledged that the city was resorting to undesirable budgeting practices to meet its responsibilities to the public—practices which have always been known to the underwriters. But, those sophisticated in city finances recognized that the borrowing and the gimmickry were the product of common consent by all concerned—by all political leaders—and by all levels of government, and with the full knowledge of the financial community, in recognition of the very special and enormous burdens which the city of New York must bear.

When I assumed office in January 1974, I publicly called attention to the existence of a $1.5 billion budget gap and recommended programs to eliminate it. Yet, financial institutions which had provided the city with credit when they knew of this large gap, have become reluctant to loan money in the very face of reforms and economies, already underway.

Those reforms will achieve a truly balanced budget; a reduction in the amount of borrowing for short-term purposes; establishment of productivity programs and job reductions; transfer of expense items from the capital budget; and, development of long-range fiscal planning.

In short, it is ironic that, at the very period when this city had undertaken real economies, established an austerity budget, and instituted major reforms, the money market, so vital to our recovery, disappeared.

We also ought to know whether the people who inhabit the city of New York in 1975, and the people who have been elected to run this city in 1975, must pay some form of penance because of real or imagined sins of the past.

Is it possible that the financial community would withhold credit from a city of 8 million people because—as had been noted by officials in Washington and echoed within New York State—the city of New York must be made an "object lesson?"

And so, at the very time when we must develop approaches that are sensitive to the troubled economy and to the needs of a restive community, we are forced to turn our backs on the critical economic and social problems of our cities to do battle with a fiscal crisis that need not have taken place.

(7) I believe that conservative elements within the financial community took advantage of the contributory factors I have cited and

added still other complications on their own. They began to press for operating and budgetary changes which, cloaked in the guise of good fiscal management, were indeed efforts to dictate the social and economic policies of our city government.

Still others, perhaps panicked by these series of events, began to give unwarranted credence to rumors and innuendos relating to the soundness of the city's obligations.

This approach, based not on the intrinsic integrity of the city's paper, but on all of the other factors I mention, surfaced publicly on March 19 of this year, when a representative of First National City Bank told a congressional delegation that New York City's fiscal situation was "not viable." He circulated among the Congressmen a statement in which the bank said flatly that "New York City paper (is) suspect regardless of interest rate."

This account was carried nationally in the Newhouse papers, and in the next morning's Times, it was noted that a First National City Bank official was quoted as having said that the bank would not buy New York City securities because investors are convinced that, if the city's money ran out, the city would pay its employees and default on its debt payments.

The net effect of these damaging statements spread like wildfire throughout the financial community, creating confusion and fear among investors.

And, despite the fact that the New York financial institutions had as much to lose as anyone else by default, there seemed to be a common approach on their part to do nothing to restore public confidence in the city's financial integrity. The result was a lost market—which will require massive efforts by all concerned to restore.

Efforts by the financial community to join with the city in seeking help from Washington and Albany for aid also became blunted. What was first a common appeal by the city, State, and the financial community for Federal assistance suddenly reversed field. We found, instead, the city and State being told to work out their own solution, which we have attempted to do.

I fully support the need to establish fiscal safeguards to insure that a city can meet its operating and debt obligations. However, we must also find the means to protect a city from economic panic—to prevent a run on its credit—just as there are laws to protect financial institutions from the same fate.

It appears that what has happened to New York could happen to any city. We still remain in jeopardy so long as our local governments, which do not have the power to print money or regulate credit, must be subject to the market forces of the financial estate.

We are beyond the point of finding villains in New York City's problem. We must look immediately to solutions that can prevent such situations from occurring in any State or local government.

I respectfully urge this committee to consider the following:

(1) I believe a Federal guarantee of repayment should be established for all State and local borrowing that qualifies under specified criteria.

The city of New York, for example, has gone a long way to convince investors of the soundness of our obligations. But, capital will remain scarce, and investors will remain sensitive to every whisper of risk. Neither the Nation's economy, nor the public interest can tolerate the kind of paralysis which uncertain credit produces in governmental operations.

The Federal Government already guarantees certain loans considered to have high priority, housing loans insured by FHA and loans to business ventures, for example.

Several bills to accomplish guarantees of State and local government obligations have been introduced in Congress.

Any guarantee by the Federal Government could be secured by future payments of Federal aid to the State or local government.

(2) The Federal Reserve System should be encouraged to extend loans to State and local governments in emergency situations. Such loans are often made to banks and should be readily available to governmental borrowers as well.

The Federal Reserve does have limited authority to make loans under current law, but the amount authorized may be too small to deal with real emergencies, and the Fed has shown no inclination to make such loans.

(3) To expand the market for State and local government borrowing and thus to reduce the cost of such borrowing to State and local taxpayers, I believe the committee should consider the following:

(*a*) Commercial banks should be required to invest specific percentages of their assets in the obligations of the city and the State in which they do business in order to qualify for the tax shelters and tax credits they have on their Federal, State, and city tax returns.

This is only fair. Banks in many cities have been accused of refusing to make mortgage and business loans in central urban areas, "redlining" whole districts while investing heavily in nearby suburban areas.

It is worth inquiring whether this pattern of "exporting" funds also applies to investing in local government obligations.

(*b*) Banking laws and regulations should be reviewed to determine whether the kind and number of tax shelters, other than State and municipal bonds and notes, should be restricted.

Tax shelters and tax loopholes constitute a major issue of public fiscal policy. For example, a major reason why commercial banks have lost some of their appetite and "need" for investments in municipal bonds and notes is their ability to take credit for foreign taxes paid abroad.

(*c*) I have previously proposed legislation to authorize a Federal agency to make loans to State and local governments. The agency would issue bonds and notes that carried the full faith and credit of the Federal Government. The interest paid by the agency would be taxable, like interest paid on Treasury bills, and should be comparable to the rate on other Federal notes.

The agency would then loan these funds to eligible State and local governments, supported by future payments of Federal aid. This would mean the ultimate municipal borrowers would pay no higher interest than the Federal Government; indeed, inasmuch as the lenders would be paying taxes on the interest they earn, the Federal agency could use these taxes to reduce the interest rates to State and local governments.

(*d*) Under this market approach, I urge continued consideration of an option for local governments to issue taxable bonds and notes. Inasmuch as interest paid on such bonds and notes would be taxable, the interest rate would be higher than tax exempt interest. However, the Federal Government would be collecting taxes it would otherwise not receive, and would use these taxes to provide a direct subsidy to the local government issuing the bonds and notes.

(4) There should be a review of the extent to which Federal aid practices and policies contribute to the cash flow problems of State and local governments. Payments of Federal aid should be synchronized, as much as possible, with the expenditure requirements at the local level.

(5) Finally, the Federal Government must assume the cost of functions which are properly national responsibilities. While I do not believe that this hearing is the appropriate forum for an extended discussion of this matter, it should be clear that no local government can continue to use its limited local resources to pay for national obligations.

Thank you.

Mr. ROSENTHAL. Thank you very much, Mayor Beame.

This was a very thoughtful, cogent, and incisive statement.

I think that it is appropriate, very frankly, for someone who is a sympathizer and a friend to ask you the most difficult question.

Many people in Washington have made the charge that the city of New York has been guilty of waste, mismanagement, of indulging in excesses in union contracts; that its wages and pensions have gone beyond fiscal propriety; that there has been bookkeeping gimmickry in the city of New York; that part of that gimmickry has been taking operating budget expenses and putting them into the capital budget; that there has been a failure to recognize budgetary limitations in terms of continuing programs where funding would not be available; and, finally and, perhaps, most intriguingly of all, that you have such a reputation and so much experience as a budget director, you must have known all of this was coming.

How do you respond to this series of charges?

Mr. BEAME. As mayor, of course, which I became on January 1, 1974, you have the power to correct these things.

In any other capacities, you don't.

As mayor on January 1, when I inherited and found this billion-and-a-half budget gap I have referenced to, I began immediately a program to cut that back eventually.

We have, since January 1, 1974, and into the next budget, and will have economies and cuts in services totaling $1,300 million.

These are going to affect our services very seriously in terms of garbage collection, in terms of the amount of police protection we would like, and in terms of the operations of the school system, of hospital and health care.

Back in March, I came out with a 10-point program which I said I was going to follow. It incorporated many of the things you just mentioned, among which was that we were going to stop this procedure of having capital budget items—expense budget items—financed out of capital funds. We have begun that in the budget which we adopted the other day, that is, for the period beginning July 1, 1975.

Also, we decided that we were going to cut down on our temporary borrowings and take other steps which would enable the city to better plan ahead in terms of the fiscal needs of our city and for which, incidentally, I just appointed a very prestigious committee to report on the future of our city in terms of its long-range needs and how to meet them.

Mr. ROSENTHAL. Mr. Mayor, the Big MAC solution appears to be a temporary solution. Will this financing crisis erupt again some time later this year?

Mr. BEAME. It is difficult to know what is going to happen.

It is obviously a temporary solution in order to get us over a hurdle. We had a June 11 problem, which was met by several actions—one by the State advancing some money, by our getting in prepayments of real estate taxes, and, also, by the banks agreeing to roll over some indebtedness which was due or which they had on June 11.

As to what is going to happen in the next 3 months, it is very difficult to know. We hope that the purpose of the Big MAC which was to basically extend about $3 billion in short-term notes or short-term bonds into long-term bonds, we hope that they will be able to do it.

However, I do think that it is important that the city itself—or at least its credit position, the interest of the markets be stimulated in order that eventually we can get back into the marketplace.

Mr. ROSENTHAL. Mayor Beame, do you think the New York banks have attempted to exercise undue influence over political and social decisions of the city?

Mr. BEAME. I think that the best illustration of that might be in the document which I said the First National City Bank had issued wherein they indicated that the city had to cut back and wherein we are now finding that the Albany situation where we are looking for taxing powers is affected to a great degree by the judgment of what the financial community thinks a satisfactory balanced budget is.

In other words, their opinion is being sought on what a satisfactory balanced budget is.

So, obviously, I would presume that what we are going to be forced to do in cuts which will be in essence the result of not getting adequate powers that we are seeking in Albany, what we will be forced to do will be based on the judgment of the financial community of what we should cut.

Mr. ROSENTHAL. Do you think that the influence they will attempt to use in this area is beyond the bounds of reasonableness?

Mr. BEAME. I took the position with the financial community that we are going to have a balanced budget by recurring revenues.

It seems to me that it is more counterproductive to the city of New York to have to cut into vital services which could drive people out of the city and which would make it very difficult for people to obtain proper services in the city, than certain forms of taxation.

Therefore, by being pushed into cutting the budget, we are in essence going to find that we are doing things which are not in the best interest of the city.

Mr. ROSENTHAL. Do you think that the attitude of the banks was inappropriate and/or unwarranted?

Mr. BEAME. I indicated to the banks very clearly many times that I don't think that they did what they should do to help restore confidence in the marketplace.

At no time did I find them indicating or counteracting the campaign— the bad-mouthing campaign—which had been going on in the marketplace.

Mr. ROSENTHAL. I think you said that the things they complained of they had been party to all through the years?

Mr. BEAME. Absolutely.

As a matter of fact, I tried to emphasize the irony of the situation. When I came into office in January, there was a billion-and-a-half budget deficit gap. From January 1, 1974 to March 31, 1975, we had 21 sales—short-term notes—and the banks during all that period knew of our budget deficit, saw us working to reduce it, and then during that latter period when we start cutting into it heavily with, as I indicated earlier, economies and cuts which are going to show up to the extent of $1.3 billion, at that point there was a drying up of the market.

Mr. ROSENTHAL. Why do you think that happened?

Mr. BEAME. This is something which I wonder about myself and I urge this committee to take a look at it.

I would like to find out why it happened, what caused all of this drying up during all this period when we were really trying to correct things.

We were getting all the loans all the time when we were doing what they felt were not the right things.

Mr. ROSENTHAL. Just one last question.

I know that you met with President Ford, Secretary Simon, and Chairman Burns over this problem.

Can you just generally tell us what their response was?

Mr. BEAME. I originally met with Secretary Simon who, by the way, used to be the chairman of my committee when I was comptroller. We had a management committee which would advise us on how to borrow, when to go into the marketplace, and so on.

I met with him many months ago and pointed up to him how these borrowings which we were making suddenly began to veer from being up to 200 points less than interest costs than Treasury bills to more than 2 or 300 points above the costs of Treasury bills.

When I mentioned that to him, he was very much surprised because New York City obligations are always sold below Treasury bills. He immediately asked his assistant to take a look at the thing. Nothing very much developed from it.

Then, there was a meeting which we held with Secretary Simon at the request of the three major banks at which Governor Carey and Chairman Burns were both present.

Again, the situation was laid out as to the importance of trying to get some Federal assistance.

However, the upshot of the whole thing was that the State ought to do it, the State ought to help, and, of course, the State did what it could, but the State could not have the facilities and the resources to help in this situation. There was no inclination on the part of Federal Government to help—just a lot of lipterms.

We met with the President and the head of his Economic Council, the Vice President, Governor Carey, and others.

Again, thereafter, we sought their help, sought the same kind of guarantee. We did not ask for money. We sought the same kind of guarantee which they had given, as I indicated, to Lockheed, Penn Central, and others.

The result of that conference was fruitless.

Mr. ROSENTHAL. Congressman Brown?

Mr. BROWN. Thank you, Mr. Chairman.

Thank you, Mayor Beame, for being with us this morning.

Mr. Mayor, the first thing that called my attention was at the bottom of page 3 and at the top of page 4 of your statement the part wherein you say that:

> The growth of the New York City budget in other-than-housekeeping functions, primarily those mandated by state and Federal law, is another key factor in our cash crisis. In the past 10 years, the personnel carried by the city for housekeeping functions (police, fire, sanitation, water supply, sewers, etc.) decreased by 4 percent. Those employed in Federal and state-aided programs increased 37 percent.

Would you expand upon that statement, please, especially with respect to your statement that the growth of the budget was in activities primarily mandated by State and Federal law?

Mr. BEAME. Actually, the number of personnel employed in the areas which, normally, represent city operations—normal city operations which we call housekeeping, as I indicated and outlined—actually dropped by 4 percent in these 10 years.

However, the Federal programs have caused an increase in personnel to the extent of 37 percent. Along with it, it meant that we would get a Federal and State——

Mr. BROWN. But, Mr. Mayor, which Federal programs have prompted this increase of 37 percent?

Mr. BEAME. As I say, it is Federal and State aided. I made that point.

It is, for instance, in the area of medicaid, the area of variation of welfare costs, the area of higher education—or rather education, and so on.

There are many of them. I certainly could get a list of them for you.

However, by and large, it also meant that there was more cash which would be reflected as receivable in our budget from these levels of government, but which we had to borrow against because the cash does not come to us when we make the expenditure, usually. It comes after.

This, obviously, increased our needs for more bonds.

That is why one of the things I offer as a thought is that, if there can be some kind of an approach to better synchronize the Federal payments——

Mr. BROWN. That may be a timing problem, but the two or three measures that you mentioned—medicaid, welfare, assistance payments for taking over SSI, and things of this nature—those things were all done with the intent of assisting State and local governments.

Mr. BEAME. I don't quarrel about that.

Mr. BROWN. Maybe, if these things are not helping, we ought to eliminate them.

Mr. BEAME. Congressman, I think you have got—you are interpreting this in the wrong way.

I am not saying that those things should not be done; we welcome them.

The point I was pointing out was a fact of life; that, in order to show that we need to get—and this was between both the State and the Federal governments—a balanced synchronization of the aid closer to the time that we actually have to make the expenditure.

This would preclude the need to go into the market for more short-term bonds.

Mr. BROWN. Mr. Mayor, if there is no problem of substance, but only a matter of timing, it seems to me that those who were examining your efforts at borrowings would see that and that this would not affect your ability to borrow.

Mr. BEAME. Unfortunately it has.

For example, we have money due us from the Federal Government and revenue sharing which is in our budget for the current year. We don't get that until—I don't know the exact date, but we will not get that in time. We have to borrow against it.

We have receivables which are part of our budget which is balanced for the year ending June 30, 1975. Those receivables run into maybe $1 billion. We have to borrow against that.

Unfortunately we were not able to because the market dried up.

Mr. BROWN. Mr. Mayor, following up on what the chairman said, I have heard allegations, for instance, that a low income family living in the city of New York if it avails itself of all of the public assistance programs that are available to residents in New York—this means Federal, State, and city supplementations—can get a sum equal to what a person has who has a taxable income of $25,000. Is that a true or false statement, do you know?

Mr. BEAME. I would say offhand that I don't think you are right. I don't know of any such situation.

If you mean the regular welfare payments which are, by and large, mandated upon us by both State and Federal Government regulations——

Mr. BROWN. I suppose it means all of the programs of the systems which are available: Federal, State, but especially the supplementation that the city of New York provides.

I presume that that was what was meant.

Mr. BEAME. I certainly don't agree with that figure now.

Mr. BROWN. I understand that the city of New York gives a resident college education on a tuition-free basis. Is that correct?

Mr. BEAME. That is correct.

Let me first say that this is a 128-year-old tradition in the city of New York.

No. 2, let me also say that in the budget which we have for 1975–76 adopted for higher education, we have asked them to increase fees to the extent of some $40 million in areas which will not affect tuition.

Mr. BROWN. I am not criticizing. It is a commendable objective. The only thing is that all of these programs, it seems to me—if you have a tuition-free program without a needs test—basically you are subsidizing those who can afford to pay. It seems to me that this creates a substantial burden upon the local government of New York City where it is not really satisfying any particular need.

Mr. BEAME. In the first place, I might say with respect to the free tuition policy that it is tied in with a scholarship program. When one analyzes this, in some of these instances—in many of these instances—the family based on the table of the scholarship program could be paying much more in tuition even though they are in the lower grade—let us say, a $7,500 category, a $7,500 taxable income—and is permitted to get a scholarship of $200 toward the tuition.

If they have two children in there, it costs them $400 on the basis that the fee that would be charged to them would be $400, $200 would be a credit. It would be a lot more than some of the costs they now have whether it be in the form of income tax or otherwise.

It does not work out that this is necessarily an area where it is going to be that kind of advantage to the higher education system financially.

Mr. BROWN. Mr. Mayor, does New York City have the same problems with respect to the rating of its borrowings whether they be in the nature of a full faith credit obligation or a revenue obligation?

Are they all facing the same rating problem from the standpoint of cost, or do your full faith and credit bonds sell at a better rate, or are they all the same?

Mr. BEAME. We have revenue anticipation notes; they are not revenue bonds but they are backed by the full faith and credit of the city.

All our obligations are full faith and credit obligations.

Mr. BROWN. I understand that there has been some emphasis, if not initiatives, placed by the Mortgage Insurance Co. and similar institutions to insure municipal obligations.

Have you explored that avenue?

If what you have said earlier—that your problem, that is, your budget gap is primarily a gap caused by the timing of receipts, these are the payments of expenditures—if it is primarily a timing thing, then it seems to me that your obligations could be insured and would get a much better rate.

Have you explored that avenue at all?

Mr. BEAME. No. I think they should be a Federal. That, I think, is a possibility and I believe that such a bill has been introduced into Congress—somewhat like an FDIC bill—with respect to the ability to insure local government obligations which would carry with it some kind of Federal guarantee with an insurance payment, just like the banks now have under the FDIC; they have that protection.

Mr. BROWN. Mr. Mayor, aren't you concerned that, if you got into a Federal guarantee program, criteria, eligibility standards, and all of these things would be part of it, which would get the Federal Government right in the area that you have criticized the banks for being in?

In that regard, I refer you back to that sentence in your statement where you said, talking of financial institutions, that they began to press for operating budgetary changes which, cloaked into the guise of good fiscal management, were indeed efforts to dictate the social and economic policy of our city government.

Would you not just substitute the pressure and coercion and so forth of the Federal Government under its criteria for that?

Mr. BEAME. Let me put it this way. A local government need not take advantage of it if it does not want to, but if a local government wants to, it would meet whatever those criteria are.

Mr. BROWN. Thank you, Mr. Mayor. My time has expired.

Mr. ROSENTHAL. Congressman Drinan?

Mr. DRINAN. Thank you, Mr. Chairman.

Welcome again, Mayor Beame. We are happy to have you here for this critical problem.

As you know, this subcommittee has oversight jurisdiction of the Federal Reserve Bank and of the Federal Deposit Insurance Corporation.

With respect to those particular agencies, what could the Federal Reserve or the FDIC do for you at this particular time if they were so inclined?

What did Arthur Burns specifically say to you at the meeting that you had with him?

Mr. BEAME. He did not speak to me specifically. He did not indicate any observation of what his conclusions were, but I called him on some related matter a day or two later and he was very discouraging, of course.

Mr. DRINAN. Mayor Beame, what authorization, what law would the Federal Reserve have right now that would be of assistance to your city?

What authority does he have to give guarantees?

Mr. BEAME. I understand that they have authority to make loans up to a limited sum.

Mr. DRINAN. You mentioned that.

I would be interested specifically in having your staff, and your attorneys give us an explanation here as to what the Federal Reserve could specifically do for you with regard to that limited authority?

As you may know, Mr. Mayor, Senator Humphrey has filed a bill precisely along the lines that you mentioned; in 1473. This is a bill to establish a national domestic development bank to provide an alternative source of credit to State and local governments for the purpose of financing public and quasi-public facilities of all types.

I am very interested in this bill or a variation of it. I am inclined to think that this subcommittee could or would have jurisdiction over something like this. But that is a new legislation.

What could the Federal Government do for you, and specifically, these agencies, that they are not doing?

Mr. BEAME. Of course, I don't know all of the rules of the Federal Reserve, but I am sure that the Federal Reserve System at one time or another has indicated to some banks that they can go out and buy certain types of things and the Federal Government—that is, the Federal Reserve—would advance them the necessary funds to do it. They served as agents in the past.

Mr. DRINAN. Would you say that the Federal Reserve was unsympathetic, uncooperative, and that it really did not want to assist New York City, that they were discouraging and that they did not want to use the full panoply of powers that they have?

Mr. BEAME. I believe so.

Mr. DRINAN. All right. Thank you.

Mr. BEAME. As a matter of fact, let me just quote something.

The New York Times on May 15 wrote of a briefing by Federal Reserve Board Chairman Arthur Burns that Congressman Mario Biaggi who attended quoted Mr. Burns as saying, "The fiscal collapse of New York City would not be a national tragedy but a local problem." At the same meeting, Mr. Burns was quoted as saying that a prudent man would no longer invest in New York City obligations.

He then denied the statement.

But then, Business Week had an article on June 2 which in essence said that the Federal Reserve Board admitted that Mr. Burns did tell a New York State delegation that any bank lending money to New York City could open itself up to share all the suits for violating the prudent man rule of investing.

There was no sympathy at all on the part of the Federal Reserve.

Mr. DRINAN. Mayor Beame, I would like to have a documented case against the Federal Reserve.

I think that they have broad powers, as you suggested, and that it is clear in the law that they in this situation should use those powers to the full.

From everything that I hear from you, neither Dr. Burns nor President Ford was sympathetic.

What precisely did you and Governor Carey ask President Ford to do in the hour that you had with him?

Mr. BEAME. To give us the same kind of treatment, as I said, was given to the Lockheed and to Penn Central.

Mr. DRINAN. Why precisely did he refuse?

Did he say that he had no authority?

Did he know about the powers of the Federal Reserve Board?

Mr. BEAME. He said he would like to have 24 hours to think it over. Among other things which were quoted in the papers, he asked us to increase the fare in New York City.

At this, as I indicated then, I was surprised because I had complimented the President on his action in helping, not only New York City but all cities of the country, to save them from a fare increase.

This seemed to be a reversal.

Mr. DRINAN. In the absence of new legislation in which we are very much interested, would you give the subcommittee precisely and specifically the two or three or four things that you think the Federal Government could do and should be doing for New York City today?

Mr. BEAME. I think it is not only New York City.

Mr. DRINAN. I am thinking of Boston, Mr. Mayor, even more than of the fun city!

Mr. BEAME. I think it is best explained in the documents I gave that there should be some kind of Federal guarantee of repayment or a mechanism set up by which the Federal Government could advance money against future Federal aid.

Mr. DRINAN. I think that is a very creative idea, but it may take legislation.

However, it may not take legislation and I want to know the things that the Federal Government could do for you, for New York City today without new legislation.

Mr. BEAME. They could help us in terms of giving us certain forms—for example, let me point out one to you.

We have a million illegal aliens in New York City. You have to give them service. They go to the schools. We did not bring them in. The Federal Government let them in. It is their problem.

However, in counting the aid which we get, they have formulas whether it be under trends in our education or others, and the formulas deal with population basically. But they don't count the aliens in the population.

So, as a result, New York City is not getting its fair share in that regard.

Second, New York City spends a great deal of money—and so does the State—on the narcotics problem. We have 51 percent of the addicts in New York City. That problem was basically caused by the failure of the Federal Government to prevent these narcotics from coming in.

Of the total Federal budget on aid for treatment, New York City gets a minor percentage, maybe 7 percent.

Mr. Drinan. Mr. Mayor, I accept all of those and I am not certain that they require new legislation but, if I may bring you back to the banking situation, to the Federal Reserve, to the Federal Deposit Insurance Corporation, to the powers that Arthur Burns has, to the inherent powers and the statutory powers that President Ford has, I would like to have once again some specific things that were denied you by Dr. Burns and by President Ford, which, in your judgment, and in the judgment of your counselors, you are entitled to. And we, as an oversight committee, would try to help you get that to which you are entitled.

Mr. Beame. Obviously, we sought help from them because we don't have the knowledge of all these administrative powers of the President and of the Federal Reserve Board. We asked for their help.

We know that they did things for nongovernmental agencies, and for businesses. We asked that they do things to help us.

We will be glad to submit specific suggestions which our staff will get out if there are things that can be done without special legislation, but I think that the basic problem here can only be cured by some form of rational action and approval by the President of some kind of a mechanism which will avoid the situation from happening throughout this country.

Mr. Drinan. Mr. Mayor, I appreciate that. My time is running out. I would just suggest that, possibly, the bank examiners now have statutory or inherent power to compel or induce the New York City banks to give more of their assets to New York City. I hope, and I know, that the mayors who, 5 years ago, were very successful in getting general revenue sharing through are going to lobby very hard for S. 1473 or some variations thereof so that the Federal Government—as it does for small business associations, as it does in other areas—will be able to give guarantees and loans to cities and municipalities and States.

Thank you very much, Mayor Beame.

Mr. Rosenthal. Congressman Gradison?

Mr. Gradison. Thank you, Mr. Chairman.

Mayor Beame, it is a pleasure to have you as a witness today. Before I got this job, I spent quite a number of years in local government including service as mayor of a city. I thought it was a large city, but it was not as large as yours.

I was interested when our former colleague Governor Carey took office, and said something in his inaugural address about the days of wine and roses being over. I think that was his phrase or something very close to it. I start to see now what he was talking about.

My appreciation of this, based upon involvement in local government finance for about 15 years, is that credit is based upon a very fragile commodity called confidence. It is obvious, from what you said, how fragile this really is.

I am concerned about a couple of points. I would like to get your comments on them.

I don't see in the national figures any indication of a reduction of loans being made to State and local governments as a whole. It sounds like the problem is the ability of New York City, and perhaps some other cities, to get their share.

However, my best recollection is that, year by year, the volume of loans outstanding by State and local governments has been going up. I think, therefore, that this really gets to be a question of competition among cities and which ones are going to get the highest rates and which ones are going to get credit on the best terms.

What these cities do competitively, one against the other, to look the best in the marketplace—and perhaps that is part of the problem here—is really the question.

I first want to thank you for some of your suggestions about what Federal Government should be doing. I read them.

What I read you to have said is that, by certain of its actions, the Federal Government has made your problems worse.

For example, the inflationary policies of the Federal Government which helped create this recession have made the problems of New York City worse. I am not trying to put words in your mouth, but I think that is what you said.

To me that suggests that one of the highest priority things that we can do to help cities in general is to deal with the problems of inflation and to deal with the problems of recession, which are tightly intertwined.

The second thing, with regard to this committee itself, I think what we could do is to speed up our consideration of general revenue sharing and its extension and its expansion.

I, for one, have been very disappointed by the fact that this committee has not already held hearings to make recommendations to the full House on this matter because it helps in local financing to know, as far ahead as possible, how much you are going to get.

There is no way for New York City or any other city to know what the future of general revenue sharing is, when we have not even held hearings on the matter and, more or less, come up with decisions.

The third observation that I have is that, from listening to you, the more the Federal Government borrows, the greater the risk there is of crowding out not just the borrowers in the private sector but in the public sector as well. I think that that has been lost in a lot of discussions and in a lot of the conversations which had to do with crowding out of private businesses without recognizing that in the competition for credit State and local governments have to compete with General Motors or American Telephone, as much as with Boston or Cincinnati—which is my hometown.

I would like to ask first roughly how much do you have in pension funds which cover the city of New York—just very roughly?

Mr. BEAME. In pension funds?

Mr. GRADISON. In pension funds.

Mr. BEAME. We have five pension systems—one for teachers, another for police, still another for fire, one for all the other city employees, and then there is one small one for what they call the "administrative employees of the system."

I would say in rough figures that our pension funds—our pension assets—are about $7 billion.

Mr. GRADISON. What proportion of those funds are invested in the obligations of the city of New York?

Mr. BEAME. Let me make an observation about that, if I may.

When I became comptroller in 1962, the pension funds amounted to about $3 billion then, $2 billion of that was in New York City bonds and securities. I felt that it was ridiculous for a fund, which was tax-exempt, to go out and buy tax-exempt bonds because of the return being so small and we did not need tax exemption.

What I did was to set up a diversification of investments. We began to invest in stocks and in commercial paper, and so forth. We began to get rid of the New York City bonds. We got rid of about a billion and a half.

I came back as comptroller in 1969 and we continued that policy. Last January—or thereabouts—when we found that we were getting the beginning of the drying up of the market which occurred really in February and because the interest rates were now so abnormally high, I asked our pension system to start investing in city bonds.

So, since about March or thereabouts—maybe a month or two earlier—there have been $700 million, I mean, several hundred million dollars from the pension funds invested in city obligations—short term and long term, but mainly short term.

The point I am making, however, is that I don't believe that our pension systems under normal circumstances should buy tax-exempts because they are of no value to tax-exempt operations. They should get as high a rate as possible but, in view of the abnormally high rates that we are paying, it was a good investment and, at the same time, it showed the confidence of the system and, much more important, it helped us out.

Mr. Gradison. I am puzzled. Our distinguished colleague, Father Drinan, has talked about possibly requiring banks to put a certain proportion of their funds in tax-exempt bonds and indeed you have had a recommendation in your list of suggestions much along the same lines, on page 11, "Commercial banks should be required to invest a specific percentage of their assets in the obligations of cities and States in which they do business."

As you pointed out in your own testimony, the effective tax rates of many banks is dropping substantially for a variety of technical reasons. Therefore, tax-exempt bonds may not be any more attractive to many banks from a point of view of net income after tax than they are to a pension fund.

Mr. Beame. I don't agree with that.

Mr. Gradison. You are referring to the foreign credits and the use of tax shelters?

Mr. Beame. No, I am just saying, generally speaking, banks or private operations and a tax-exempt instrument to them gives them double almost the value of earnings than are nontaxables.

Mr. Gradison. If they are fully taxed.

If, through the use of tax shelters, and so forth, their rates are——

Mr. Beame. Shelters also have their advantage.

Mr. Gradison. I am wondering, sir, whether it is consistent to argue that a bank should concentrate or be required to make a certain percentage of its investments in the community where it does business, but not to make a similar requirement of your own pension funds.

Mr. Beame. Let me make this observation, with respect to that.

We are getting most of the cash flow now—you remember, when I said that our pension funds are $7 billion, that is not in cash.

Mr. GRADISON. It is in marketable securities, to a large extent, is it not?

Mr. BEAME. Yes.

Mr. GRADISON. They could be sold and reinvested in your bonds, couldn't they?

Mr. BEAME. Now you are asking a system—and remember this is not belonging to the city of New York; the system does not belong to the city of New York, that is, the assets of the members—to sell and reinvest. What that would mean is to liquidate the portfolio and cause undoubtedly a lot of losses in order to get cash. I think that that is certainly not acting in the best interest, fiduciarily of course, I am talking of the members.

In addition to that, in the final analysis that deficit would have to be picked up by the city.

Mr. GRADISON. What deficit? The interest rate deficit?

Mr. BEAME. Yes. The losses would have to be picked up by the city.

Mr. GRADISON. I would merely suggest that, in a lot of these things, the first line of protection is to see what we can do for ourselves. It seems to me that one possible source for the purchase of those investments was your own funds, then the State, and then the Federal Government.

I notice, with regard to the Federal Government, on page 10 you suggest that there should be a Federal guarantee. You say at point one, "I believe a Federal guarantee of repayment should be established for all State and local borrowings that qualify."

Mr. Brown, quite properly, raised the question of whether you are not going to have much the same controls from the Federal Government as the conditions for its guarantee that you have from the banks today. Frankly, I think you would.

Mr. BEAME. I would not have any hesitation.

Mr. GRADISON. I beg your pardon?

Mr. BEAME. I would not have any hesitation of Federal Government, if we want to take advantage of that loan. We are not required to, but if we want to take advantage, I have no hesitation about a Government agency setting forth criteria.

However, I do have some objectives to having any private group of bankers, or anyone else in the financial community, dictating any social or economic policies of any government, any level of government.

Mr. GRADISON. I realize my time is expiring.

I would just like to point out that, when you deal with the Federal Government, you are dealing with a single entity. If you are not satisfied with their decisions, there is nowhere to go.

But, if you are dealing with private lenders, they don't always speak with one voice; there are commercial banks, there are underwriters; they don't always say the same thing, nor do the rating services.

It really bothers me to see you complain, on the one hand, about the Federal Government—and quite properly, I might say—compounding your financial problems by the timing of its payments for

Federal programs and so forth, which suggests that the Federal Government does not do everything perfectly, and then suggesting when it comes to the controls which they would necessarily impose as conditions of guaranteeing your borrowing, that they would necessarily be much more reasonable to deal with than people in the private sector.

I find that hard to buy, very frankly.

Mr. BEAME. As I indicated earlier, if the criteria of things are objectionable to any community, they will not go there.

But, certainly, it seems to me that we should have an opportunity to be able to go there.

You ought to be able to have a place to go if you had to, other than to the financial community.

Mr. GRADISON. But, Mr. Mayor, are you required to participate in the programs that you criticize?

Those, basically, are all programs that are offered to communities.

Mr. BEAME. Congressman, I think you are making the wrong interpretation.

I have not criticized those programs. I think that they are programs that we ought to have.

The only point I made is to make a statement of facts, namely, that the programs which we are involved with, with State and Federal Government, have been the ones which have increased our personnel and have created additional moneys which are receivable against what we have to borrow.

I am merely pointing out as to why it is that we have to go into the market more often than we should if we were able to get that money sooner.

I am not quarreling about the problems. I hope you understand that.

Mr. ROSENTHAL. Congressman Levitas?

Mr. LEVITAS. Thank you, Mr. Chairman.

I thank you for being with us this morning, Mr. Mayor, and for providing the very provocative and interesting testimony you afforded this committee in dealing with this problem.

I recognize that the point that you make to this committee is that New York City is not in a unique position. It just happens to be in a very visible position right now.

This morning, for example, the State of Georgia Legislature has been convened in a special session by the Governor to deal with the problem—at the State level—of a budget deficit which is going to occur at the end of its fiscal year, June 30.

So, the problem that you address is not unique to the city of New York.

Perhaps the solutions that you offer are different from those which may be proposed elsewhere.

However, I would like to get first of all some basic information to help me put this in perspective.

What is the anticipated revenue expense deficit that the city of New York anticipates for the end of the current fiscal year?

Mr. BEAME. We had estimated, as a result of—as I indicated earlier—the inflation-recession period where our interest costs went up and so on, in the neighborhood of $400-and-some-odd million in increased cost which had not been anticipated, out of which we, by economies and cutbacks and layoffs, have probably made $120 million which would be the amount of expenditures exceeding our revenues.

Mr. LEVITAS. What do you anticipate for fiscal year 1976, both in terms of a projected revenue-expense deficit and a cash-flow deficit?

Mr. BEAME. Nothing.

Mr. LEVITAS. Nothing?

Mr. BEAME. Nothing on a revenue-expense deficit.

Mr. LEVITAS. What about cash-flow deficit?

Mr. BEAME. We balanced our budget and the balancing of it is one where we have had to, because we sought a program from the legislature which would have enabled us to levy taxes and ask for certain State aid, we sought a program for 641 in order to balance our budget.

We were told that we only had 150 million that would be given to us in terms of taxing powers.

We have, therefore, adopted a budget—and it was adopted last Thursday night—which is going to involve 40,000 layoffs.

Now, we are still in negotiations. We hope that we may get some more of the things we asked for, which would reduce that.

Mr. LEVITAS. I understand that.

Mr. BEAME. So, our budget is in balance.

Mr. LEVITAS. For 1976.

Now, do you anticipate a cash-flow deficit for 1976?

Mr. BEAME. This all depends upon whether the marketplace can be reopened.

Mr. LEVITAS. If it is not, will you have a cash-flow problem during 1976?

Mr. BEAME. Well, obviously we will.

In other words, if we have revenues which are due us. For example, our real estate taxes come in during certain periods or quarters. During that period, we have to borrow again until the revenues are coming, we have to do it like any other business. A business has its accounts receivable. They have got to borrow against it in order to meet their needs until the receivable comes in.

That is where our problem will be unless the marketplace is reopened.

The Big MAC, which you have read about, we hope will begin to help the situation, but I think the financial community has to come in and help us restore confidence.

During all of this period of a year or so, in which we were getting loans and in which they knew we were having deficits, they knew this. Then it was cut off. During all of that previous period I never heard anything from the financial community about them helping us to restore confidence in the marketplace.

Mr. LEVITAS. I think you have made that point very clear. In fact, I am hoping that the chairman, before these hearings are concluded, will afford the subcommittee the opportunity of hearing testimony from representatives of the financial community.

Let me go to a more fundamental, perhaps theoretical but not necessarily secondary, question.

Keep in mind that I and some Members of Congress support the idea of Federal revenue sharing and its continuation, and that I and some of the Members of Congress question the propriety of massive

Federal assistance to private corporations and therefore don't believe the analogy is well taken because it fails on the first leg.

Would you state why you believe that taxpayers in Topeka, Kans., and Sacramento, Calif., and Dayton, Ohio, should pay the cost of running the city of New York and other cities around the country which have their own programs which vary from community to community?

Also, we have the concern which has been expressed by several members of this subcommittee that would not the Federal support of local government necessarily result in the large extent of Federal control over local government with decisions being made in Washington which have not been startlingly effective in other areas as opposed to decisions being made by local people?

Mr. BEAME. I don't agree with you, Mr. Congressman, that anybody is being asked to pay for any costs in New York City.

What we are seeking here is a guarantee—no money—which would be supported by Federal aid which could be held if the debts are not paid.

Second, I think New York City is paying the expenses of the other places you were mentioning. It is not the reverse.

We sent to this Federal Government from New York City, it has been estimated, up to $20 billion in revenues. Maybe we get back $2 or $3 billion. Where is the other $17 billion?

It doesn't go to New York City. If there is anything being done, we are subsidizing other parts of the country.

Mr. LEVITAS. In that connection, how would you view the possibility or the preference of local government, such as New York City, spending local revenue sources to cover these costs rather than looking to some higher jurisdiction to provide either categorical or general revenue sharing?

I have the feeling that, where local citizens have the responsibility of paying the costs of the programs, which they are receiving, they tend to be somewhat more responsible in demanding those programs if they know that they are going to have to pay for them out of their local taxes.

Mr. BEAME. Mr. Congressman, I am sure that you are aware of the fact that there are certain costs borne locally which are the national responsibility.

Perhaps the most well-known and recognized of that is the whole cost of welfare. By reason of the failure of the Federal Government in the past years to provide adequate help to people in the places they work and live, they have migrated to New York City and other urban areas; and had the Federal Government taken its responsibility and done it properly, then that would not have occurred.

This is just one of the situations with respect to that fact.

Sure, I believe that local government ought to take care of its problems, but there is not an urban area in the entire country today that has the resources to do it.

In New York City, for example, we are the world capital. We have the United Nations there. Why should we bear the cost of the U.N.? Why should we give them forgiveness on real estate taxes costing millions of dollars a year? Why should we have to give the policing and all the services to those people? They are not our responsibility. There are a lot of other responsibilities.

But, I say to you that there is not today any urban area in this country, where 80 percent of the people of the country live, which has the resources or will have the resources to meet its problems without the Federal Government getting into this picture.

The Federal Government does not have to necessarily get in all of the time with strings attached. It depends on the legislation, but they have to recognize their responsibility, and they have to help.

I say the same thing for the State governments. There are functions which are being carried out by the city of New York which are State responsibilities. For example, we have a court system for which we pay a tremendous amount, yet the court system is operated and administered by the State.

We have a jail system in New York City which should not be borne by the city; that is a State function. And so on down the line.

I believe that there has got to be a reshuffling of the functions of government to their proper levels in order that urban areas will be able to exist in the future.

Mr. Levitas. I agree with that last point, Mr. Mayor, but that gets me back to the same question which several members of the subcommittee have been asking.

You propose, as an analogy of the Federal Deposit Insurance Corporation which has auditors at the Federal level who come in and provide standards at the Federal level for the way the banks are going to be operated, to turn over to an agency of the Federal Government the types of controls which would necessarily follow from financial support.

I am concerned to hear that type of statement from the mayor of our largest city.

Whether it is a guarantee or a grant or whatever, I hear more often local officials complaining about Federal interference and the mismanagement of programs by the Federal Government which impact upon local government.

Mr. Beame. I haven't said that, Mr. Congressman.

For example, we have in New York City, rather in the State, set up the Big MAC. That Big MAC does not have control over New York City, but what it requires is that there be certain regular reporting with respect to what information they are concerned with.

Mr. Levitas. I yield to Mr. Maguire.

Mr. Beame. If I might say, I cut this out of Saturday's New York Post:

> The U.S. Export-Import Bank gave final clearance for a $35 million direct loan and matching guarantee to a borrower, P. T. Nickel Corp., 75 percent owned by Nickel Corp., Canada with Japan owning the rest.

Apparently, there are so many ways in which the Federal Government is going out of its way to help other parts of the world but is not recognizing its responsibilities to its own citizens and its own governments.

Mr. Levitas. Before I yield let me respond to that because it has been said several times.

I think it is inaccurate and unfair to say that the Federal Government has not recognized its responsibility to State and local governments. In many, many areas we spend billions and billions of dollars on programs which are of direct benefit to State and local governments.

To say on one hand that we are not meeting those responsibilities and to say on the other hand that we are also, as a Federal Government, assisting in other parts of the economy is just inaccurate.

I think the Federal Government, as you have pointed out, has taken a very definite role in providing funds and programs that directly aid State and local governments, whether it is in the building of roads or in the administration of education programs or providing public assistance.

I think your point could validly be that we are not doing enough in some areas and in the right way.

Mr. BEAME. I will buy that: "not doing enough."

Mr. LEVITAS. But I get back to your point that I would certainly, having served for 10 years before coming here, in a State legislature, have great reluctance to see Federal Government move into the financing of the local governments, in some of the ways that have been suggested, with the strings that would be demanded be attached if a greater fusion of capital or loans or guarantees followed.

Perhaps in the remainder of the questioning you will clarify how this can be done without that type of interference.

Mr. ROSENTHAL. Congressman Maguire.

Mr. MAGUIRE. Mr. Mayor, I want to thank you for your appearance here today.

Clearly the cities of our country are key to the future of this country. If the cities collapse, then so will the suburbs and so will the Nation.

Our national policy over an extended period of time has neglected our great metropolitan centers. The transportation policies, welfare policies, and other policies like housing have tended to put additional pressure on the cities.

Of course, as you have indicated, the city of New York, like the State of New Jersey, has metropolitan areas paying many more taxes than they get back.

Of course, a city must pull itself together in terms of the financial procedures which it uses. I think there is evidence in your statement this morning that New York City is facing some of those facts now, for the first time in some years.

I am interested, though, in the fact that we have the Federal Government with some tools that we could use to assist the cities, and the fact that we also have great private centers of power and influence and wealth located in our cities and in New York, which could conceivably be used in ways that would be of assistance.

You have outlined some of those ways on pages 10 and 11 of your statement.

Inasmuch as we have already explored in the earlier questioning some of the things that the Federal Government might do, I want to ask you a little more about what some of the private institutions, including the banks, might do in a little more specificity.

Do you know the percentage of assets the banks now invest in New York City as opposed to elsewhere in the country and in the world?

Mr. BEAME. No; I don't. I have heard different numbers, but I really don't for a fact know.

Mr. ROSENTHAL. If the gentleman will yield, that is something that we will reveal during the course of our investigation here.

Mr. MAGUIRE. Thank you, Mr. Chairman.

I think that is important to know because the suggestion has been made that with the major banks located in New York, which are among the largest in the world and certainly in the United States, a tremendous amount of their assets and loan capabilities are employed elsewhere in the country and in the world.

One of your proposals, of course, is that some specific percentages be established for the commercial banks. I hope we can pursue in the subcommittee a discussion of that point, and I hope that you can provide us with some more data.

The banks also indicate that their principal job with regard to municipal obligations is to underwrite them. I hope that we will have a chance to discuss this with some bankers later, but I wanted to ask you, Mr. Mayor, is it not also the case that underwriters invest? They also advise investors in addition to providing the marketing of securities to investors.

If that is true, what suggestions could you make as to the role that the banks might play at this point? I have seen the documents that indicate that they simply underwrite and that they haven't earned a profit recently; at least, First National City maintains that it has not on underwriting.

What role could they play with the investing community at this point which would go perhaps beyond the minimum?

Mr. BEAME. I have met on several occasions with them. I set up, in order to get the banking community to really have all the data that they want on New York City, a task force of the banking community and the city. This would permit them to get any information that they want.

The head of that is Mr. Patterson who is the head of Morgan Guaranty.

I have been continuously meeting Mr. Patterson; Mr. Spencer, the head of First National; and David Rockefeller. We discuss the problems of the months.

Every time I have sat with them, I have said to them that I think that the banks have more than the responsibility of computing an interest rate in a bid and then having that bid submitted.

I felt that they have to go out and overtly talk about the strength of the New York City bonds. They have to sell them.

A salesman who wants to sell an automobile, unless he talks it up, won't be able to sell it. If he indicates by his silence or by any other actions a derogatory reaction, then he is certainly not going to sell that product.

I believe that the banks in some way have to take a more positive move and action to restore the confidence of the investing public. They have not done it.

I have not heard them issue anything in all of this period in which I have been moving to cut back on city operations and to reform the procedures. I have not heard them overtly go out and say: "There's a good job trying to be done, and it looks as if we are moving in the right direction."

This would give confidence to the people.

I don't know if you know Labenthal & Co., but they did something like that. They took a big ad in the New York papers. Sure, they are a salesman for bonds, but they buy a lot of these bonds, too; and they sell them.

Mr. MAGUIRE. Do you think that it would help if the Federal Reserve Board were to give the banks some notion of how important it is nationally that our cities be preserved?

I understand that the Federal Reserve Board, aside from whatever changes in legislation we might want to consider later on, under its present mandate has taken the liberty of, for example, urging banks to put money into saving the real estate investment trusts which in many cases were the worst kinds of investments; and it has been throwing good money after bad.

I take it that the Federal Reserve Board has encouraged banks to do that for reasons of maintaining the viability of those investments.

If the Federal Reserve Board does that in whatever formal and informal ways, which I gather have been documented by a lot of observers—Andrew Brimmer and in the magazines which report weekly on the financial affairs of the country—would we not have a reason to expect that the Federal Reserve Board would take some greater interest in encouraging our banks and our lending institutions to create a climate in which investment would continue to be available to the cities?

Mr. BEAME. I did make an observation along those lines earlier in my testimony or during the questioning.

I believe the Federal Reserve Board is just acting with a "hands off" policy.

I don't know whether you were here at the time I quoted Chairman Burns' observations where, in his mind, you just write off New York City. New York City is not part of this country.

Mr. MAGUIRE. What conceivable justification can there be for bailing out shoddy real estate investments and ignoring the city of New York?

Mr. GRADISON. Would the gentleman yield?

Mr. MAGUIRE. I would be happy to yield to the gentleman.

Mr. GRADISON. I would like to point out that, while sitting on the Banking and Currency Committee, I sat in on hearings on this subject and I did not come away convinced that the Federal Reserve ever in any positive way encouraged the banks to bail out the REIT's, nor did I think that they have ever even called the attention of the banks to this issue without qualifying that, at every point, such loans must be credit worthy.

We went into this at great length. I just want to point out at this stage that the statements which Governor Brimmer made on this subject and his recollections were inconsistent with the recollections of some others.

I am not saying that he was right or he was wrong, but I don't want to leave the thought here without raising the question and without raising some doubts in the minds of those present. I don't want to leave the thought that the Feds actively asked the banks to invest in REIT's that were in serious financial difficulty because we have not had hard evidence that that was the case, regardless of what the financial press reported.

Mr. BEAME. I might say, Mr. Congressman, that I think the Federal Reserve—if my information is right—bailed out the Franklin National Bank. It seems to me that they ought to do something to bail out some of the others.

Mr. GRADISON. I dare say that that is not correct either. The shareholders of the Franklin National Bank were wiped out entirely.

What was done was to protect the depositors up to the extent of insurance of the Franklin National and not to protect the Franklin National.

That is a very important distinction. The institution is gone; the equity is wiped out; the depositors were protected.

Mr. BEAME. I don't quarrel with that, but the point is action was taken to help.

There is no action taken to help with respect to a governmental agency like New York City.

Mr. ROSENTHAL. The time of the gentleman has expired.

I do want to point out that Mayor Maloney and Mayor Vandivier are here and we want to get to them as expeditiously as we can.

Congressman Evans?

Mr. EVANS. Thank you, Mr. Chairman.

Mayor Beame, I take it from reading through your testimony here this morning that you feel the Federal Government should have been more active in assisting the city of New York.

In terms of what the Federal Government has done however, what do you think the Federal Government has been doing wrong in terms of assisting New York City through any program?

Mr. BEAME. I think it is not what they did but it is what they did not do and that was that, when we asked the Secretary of the Treasury and we asked the Federal Reserve Board Chairman and we asked the President if there cannot be some action which could be taken by the Federal Government to enable the city of New York to have its securities guaranteed so the market can open and the rates could be low, nothing was done.

We know, and we made it very clear to the President, that that required congressional action, but we said that, if the President would say that he is in sympathy with such a procedure, we think we would have gotten congressional action.

The President indicated that he would let us know in 24 hours. Thereafter, of course, he wrote me the letter which I have before me in which he turned it down.

Mr. EVANS. On page 9 of your testimony you mentioned that what happened to New York City could happen in any city.

How imminent do you think this type of crisis is for other cities throughout the United States?

Mr. BEAME. New York City has been a leader in a lot of things. What happens in New York City usually happens elsewhere right after.

I just have before me, for example, a note saying that Detroit paid 9.8 percent on their municipal hospital bond sales.

It is getting to the point where these rates are completely out of line, where communities cannot borrow—that is, they don't have the resources to be able to borrow at those rates. The Government has got to move in to help.

The problem of New York City was not the rates alone, but it was a cash boycott. That is what happened.

We were cut off all of a sudden. What was very puzzling to me—and I stated this maybe three or four times already—is that, from

January 1, 1974, when they knew we had a debt, they knew we had deficits before, to March 31, 1975, the city went into the market 21 times—I should say 25 times—and got loans. During that very period, I was moving to cut back to institute reforms. I began in this country a layoff policy which is now being spread.

I am not saying this with any degree of pride. I am saying it rather because of the fact that I recognized the situation. We had to move. We have taken all these steps to put our city on a sound fiscal basis. While we are doing that, that is when we get the cash boycott.

Mr. Evans. Was it recognized that you were taking positive steps to put the city back in order?

Mr. Beame. If they did not believe it, there is nothing I can say.

The press was full of the things that we were trying to do. We were laying off people. We were moving to get a balanced budget without any borrowing, as had been done in the past.

However, just while we are doing this, that should have been the time we should have been encouraged. That is the time when the banks should have spoken out and said, "Look, they are trying to do something. Let us help them."

But they kept quiet. They did nothing. They allowed all this to fester, whispering campaigns and what not, and the media one on the other throughout the country picking up the stories. Not a word, not a word came from the financial institutions.

What puzzled me more is that they have so much to lose. They have got our securities.

Mr. Evans. Thank you very much, Mr. Mayor, for coming here and trying to help make the situation clearer.

Mr. Rosenthal. Thank you, Mayor Beame. We are enormously grateful for your insight and testimony here today.

As you can sense, there are differences of opinion in the country and among Congressmen as to how to resolve these problems and the nature and extents of the responsibilities.

I myself think that there will, at some point in time—when the time occurs, I don't know, a coalescence of those who have a view for a significant structure and fundamental changes in our banking and regulatory system and the recognition of a renewed commitment to our cities and urban communities.

The fact of the matter is that, as in almost all things, New York City is leading this fight. At some point in time, hopefully in the near future, I think that there will be a renewed Federal recognition of the need and vitality and the vibrancy of our cities and local communities. It may be that much of this can be accomplished without legislation. I mean Federal guarantees can be effected possibly without legislation, possibly with legislation.

This series of hearings will continue, not only with New York City but with other communities around the country. We shall meet and shall take testimony from bankers from New York City and from around the country.

It may well be that the prognosis will be a fundamental change and a sense of responsibilities in this area.

However, as I suggested, we are deeply grateful to you for shedding an illuminating light on New York's situation.

My own personal view is that were there to be default by New York City the reverberations and shock waves would be convulsive in the financial community throughout the country.

It may be that the Federal Government will tilt their emphasis in their responsibilities which will be good for all of our people in Topeka, in Grand Rapids, in Atlanta, and elsewhere.

Thank you very much.

We are extraordinarily anxious to hear from Mayor Maloney and Mayor Vandivier.

Mr. BEAME. Thank you. I very much appreciate this opportunity and I certainly will be very glad to give any information you would seek from our staff.

Mr. ROSENTHAL. Mayor Maloney?

STATEMENT OF MAYOR THOMAS C. MALONEY, WILMINGTON, DEL.

Mr. MALONEY. Thank you, Mr. Chairman. If I may, I would like to also be able to show some charts that I have here to illustrate some of the points that I would like to make.

Copies of those are available so that the committee can have them on record.

I would like to thank you, Mr. Chairman and members of the committee, for having me today, as mayor of Wilmington, and making me able to speak on behalf of the National League of Cities and the U.S. Conference of Mayors.

The subject matter today is what has become an ongoing one over the past decade—the role of the Federal Government and what its responsibilities are to the urban centers of our Nation.

I know that many congressional leaders view the crisis of our cities with disdain. You can almost hear them saying, "oh no, here come those mayors again with their hands out."

The mayors of this country are not asking for charity. We are only asking the Federal Government to balance the scales which Federal subsidies in other areas have tipped against the cities.

The appropriate responsibilities of the Federal, State, and local governments with respect to the Nation's cities is a very important issue which must be defined.

Before I discuss my views on the roles of the various governments, I believe it is important that we all have a basic understanding of how cities reached the condition they are in today.

There is also a basic question about just how bad conditions in our cities actually are. If the services cities provide today were measured against the same services of 30 years ago, I am certain they would indicate a phenomenal improvement.

More children graduate from high school; housing is better overall; sanitation has improved; and the list could continue. Actually, the condition of the cities is one of perception, and most people feel that services could be greatly improved.

Of course, there is also a question of economics in the delivery of those services, which I will touch upon throughout this presentation.

But, what actually caused the cities to begin their decline from the center of business, industry, culture, and education?

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Quite simply, it was the "flight to suburbia."

The Federal Government played a large role in this flight through the proliferation of VA and FHA loans to suburban builders, and the financing of a highway network which allowed the suburbanite to commute to work in the city with minimal difficulty.

The effect of the suburban rush has been devastating to the cities.

When people started leaving the cities, many returned every day to earn their livelihoods. Currently, Wilmington's population increases by 50 to 75 percent during working hours. These commuters require significant city services such as police and fire protection, street maintenance, traffic control, and subsidized parking just to mention a few.

Those people who remained in the city, either by choice or an inability to relocate, saw their taxes soar astronomically.

Business and industry, the largest taxpayers in cities, were forced to absorb these enormous levies. When these taxes affected profitability, firms started looking for cheaper locations. Too often, unfortunately, they found them.

When firms left cities, they often left behind unskilled workers, not to mention abandoned stores and factories.

As unemployment in major cities grew, so did crime rates.

Crimes are committed by desperate men. Their hopes for the future dimmed, they turn to crime for their livelihood. They have nothing to lose.

The increasing crime rate drove away more city dwellers, who at one time had no intention of leaving their neighborhoods.

As the suburban population grew, the business of city merchants declined. Crime in the streets also kept away regular customers.

In the suburbs massive shopping complexes began to spring up. The retailers moved to where their customers were.

Plywood began filling store windows in the city, which had been formerly filled with merchandise.

About the only things going up in cities were, and in most cases still are, taxes, the crime rate, and the daytime population.

As a partial response to these real problems various governmental programs were initiated which have compounded the problem. Urban renewal, the proliferation of public housing units, welfare programs, are a few of the programs which have had an adverse long-term effect on many cities. These programs, many of which addressed a real need, have tended to concentrate the problems they were meant to correct, thus continuing the erosion of the tax base.

My city is the site of virtually every public housing unit in Delaware's largest county. Twenty percent of our public school population comes from these Federal projects whose tenants are unable to pay property taxes. Fifty-five percent of all our public school students come from families receiving aid for families with dependent children.

One-third of our city operating budget goes to our public school system. The Federal Government does not provide impact as it does for U.S. military dependents.

Wilmington forgoes nearly $1 million annually in property taxes for senior citizen housing, both federally subsidized and privately owned.

Every hospital in our county is located in the city, and the majority of patients are suburbanites. We forgo nearly another $1 million in property taxes on these structures.

Is it the moral and fiscal responsibility of city taxpayers to subsidize our poor, our aged, and our ill, simply because of some arbitrary geographic boundaries within which they reside?

Or it is a responsibility of all Americans to share equally in the burden?

Cities cannot be responsible for the redistribution of income, because of their limited fiscal base.

Yet, cities must do everything in their power to stem the escalating costs of government.

During the period in which the city was the hub of all activity, many facilities were built which are now regional in nature. These facilities include hospitals, churches, governmental buildings, museums, et cetera, which do not pay taxes. As more businesses and citizens move out of the city and the tax base erodes, the percentage of tax exempt property becomes a major concern. In Wilmington almost 30 percent of all property is currently tax exempt.

How have the cities responded? First, property taxes were raised, thus accelerating the continued flight to suburbia of individuals, merchants, and businesses. Next, the cities looked for new sources of revenues. In Wilmington, as in most cities, the sources hit hardest were businesses. An employer paid tax based on the number of employees and a wage tax paid by all employees working within Wilmington, are examples of the counterproductive revenue measures implemented.

Therefore, raising money to provide necessary services to the remaining individuals and businesses has encouraged the further erosion of the tax base, making cities unattractive to many businesses and, therefore, less competitive and self-sufficient. Taxes which place business in a less competitive position serve to increase unemployment in the city, thus requiring more services.

The next step for the cities was to give up or transfer services to other units of government. Accepting the proposition that the local government has no business in income redistribution, the first services transferred included those in the areas of health, education, and welfare. Other services which Wilmington has transferred include the maintenance of regional parks, the library, and public transportation subsidy.

Another step attempted by cities has been the merger of activities with other governments thus avoiding duplication of expertise and equipment. Assessment and data processing are two areas in which Wilmington now purchases services from New Castle County.

Continuing inflation and Federal and State rules and regulations have managed to wipe out any gains made from mergers and transfers.

Eighty-five percent of the city's operating budget goes to personnel costs. That leaves only 15 percent for materials, supplies, and equipment.

The city can do little to fight the rising costs of materials and supplies, such as fuel for our vehicles, up 75 percent this fiscal year, or for electricity, up 95 percent, or even bulk chemicals for our city water supply, which are up 59 percent over last year.

If local taxes are to remain as competitive as possible, economies must be achieved, it becomes extremely apparent where the cuts must be made, see tables A and B. We cannot survive without the equipment or materials. We may be able to survive with a reduced work force.

The result is an increased number of unemployed workers and a decrease in their ability to stimulate the economy. It also could mean a decline in the quality of services delivered to city taxpayers.

Cities are also faced with union negotiations. The spiraling cost of living has certainly not helped in making these negotiations any easier.

In Wilmington we recently secured 3-year contracts with our police and fire departments in an effort to allow more effective fiscal planning.

Our negotiations would have been much easier and productivity bargaining a much more realistic goal had the economic situation faced by the city employees not been so dire.

The cities have begun to look inward toward productivity increases and other efficiency measures.

In Wilmington we implemented various efficiency improvements.

Over the past 2 years we have been able, through attrition and after careful study and analysis, to significantly reduce the city work force.

We have eliminated 11 percent of our city firefighting force. This reduction will mean a $½ million savings to taxpayers in personnel and capital costs over the first 2 years alone.

We reduced city garbage collection by 40 percent with no decrease in productivity. This saves the city more than $400,000 annually.

Our parks maintenance division has been cut by 27 percent, and our urban renewal division trimmed by 25 percent.

The city department of licenses and inspection is currently being reviewed with an eye toward more efficiency, and a task force has been formed to establish productivity standards for the bureau of police.

Controversy has also stemmed from the recent action by Wilmington City Council to place a moratorium on all new applications for property tax exemptions until the current tax exemption statutes can be reevaluated.

The controversy is expected. It is always expected when a change from the status quo is suggested in governmental operations.

However, there are some realities to be dealt with.

It is all too clear that city residents are penalized for living in urban centers all across the country.

Even our Federal revenue sharing funds are now being cut back because of a projected decline in Wilmington's population. We have data to dispute the Federal findings, but nothing short of another census will allow us to retrieve the 10-percent cut in our revenue sharing in the coming fiscal year. The revenue sharing allocation formula which limits a city to 145 percent of the State's per capita share means that Wilmington's allocation is reduced by almost one-third. This money then goes to the surrounding affluent county.

It is incumbent upon the leaders at all levels of government to clearly define the roles and responsibilities at each level. Unless these roles are clearly defined, the existing inequities which burden city taxpayers will be compounded. Once the clarification of roles is drawn, it will be up to each level of government to follow the guidelines that are set forward and not to exceed the limits that are set.

The cities are not asking the Federal Government for charity.

They are asking for a balance that they justly deserve to make them competitive.

The cities are only asking that the Federal Government, which subsidized the development of suburbia with massive amounts of money give the cities the opportunity to rebuild themselves.

Now, if you will permit me, I will go back to the charts.

Table A is an example of the number of cuts that we have made in about 2½ years in various operating departments in the city of Wilmington. These are quite sizable. The rubbish collection went down 40 percent, fire protection went down 11 percent, parks maintenance went down 27 percent, and the urban renewal went down 25 percent.

This is just mentioning some of the more significant ones.

At the same time we have made these cutbacks and tried to be as productive and production oriented as we can be.

Table B represents—and I am sure Wilmington is very typical in this situation—what it would cost a business to be located inside the city and what it would cost the same business to be located outside the city.

For example, here you can see that a business and a building which is assessed for $1 million and which has 100 employees whose average salary is around $10,000, you can see that the local taxes—property taxes plus a per capita tax which you pay for the employees you have—come up to $44,670 compared with $17,540 outside of the city.

At the same time, within the city we see a wage tax which here amounts to $12,500. At the same time we are trying to encourage businesses to locate in the city, to provide job opportunities, to broaden their tax bases and you can see that, from a sound business standpoint, the options are very limited.

The point I am trying to illustrate is that, even with these kinds of economies because of the redistribution positions that cities have been forced to take as far as providing social services, we are unable to compete to build a base in the city that enables us to solve some of the major problems.

I think that this is an extremely important consideration that, if we really want to save the cities, we have got to look at these kinds of problems and realistically deal with them.

I might point to another chart, table C, which shows you the kinds of revenues that are necessary to pay our bills.

As you can see, a major portion of our income comes from real estate taxes, but a wage tax plus a head tax—the employee tax—amounts to over 30 percent of our income.

So, 30 percent of our income is levied primarily on those kinds of situations that discourage people from wanting to locate in cities, who want to work in cities and, in many instances, want to live in cities.

I might point out that I mention that it becomes obvious where these cuts—if we are going to make some changes in our government—have to be made. That means that we are going to have to cut back in personnel.

So, we really cannot survive without basic equipment and materials in our cities. We have got to treat the water, we have got to put the trucks out and the police cars, and so forth.

But, we may be able to survive with fewer people working for us, with a reduced work force.

However, the result is an increased number of unemployment and a decrease in the workers' ability to stimulate the economy as a result.

It also means a decline in the quality of services delivered to the city taxpayers.

At this point, I would like to ask that the charts be included in the record?

Mr. ROSENTHAL. Without objection, it will so be done.

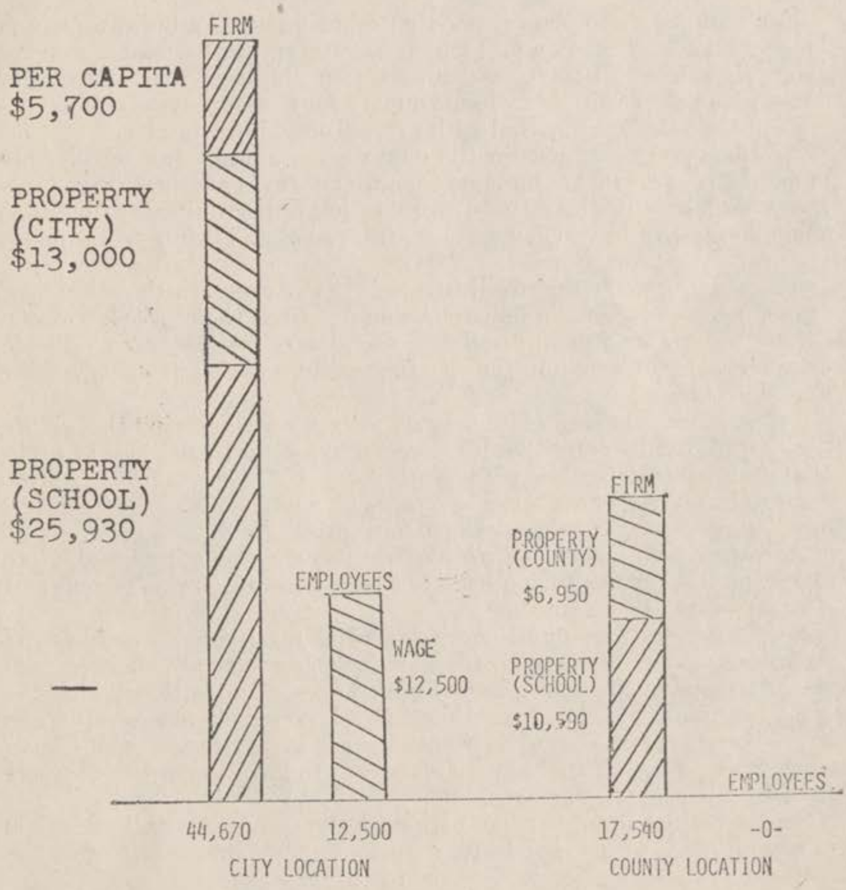
[The charts follow:]

TABLE A—ECONOMY MEASURES

Cutback

	Percent
Rubbish collection	40
Fire	11
Parks maintenance	27
Urban renewal	25

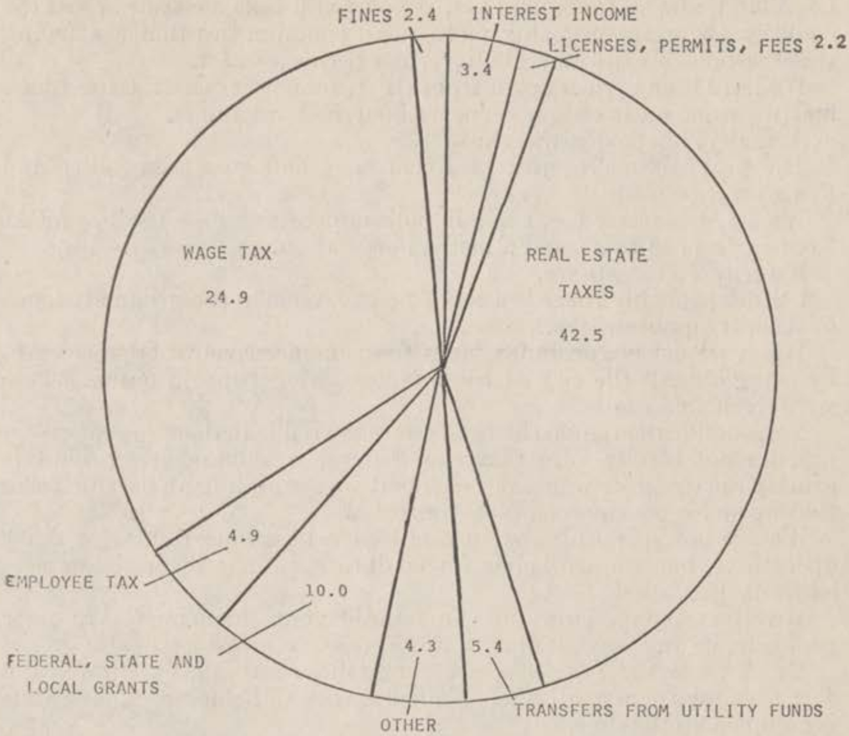
TABLE B.—Business Tax Burden



* BUILDING & LAND ASSESSMENT - $1,000,000

* 100 EMPLOYEES - AVERAGE SALARY $10,000

TABLE C.—Revenues



Mr. MALONEY. Thank you for your attention.
Mr. ROSENTHAL. Thank you, Mr. Mayor.
Mr. Vandivier, we can now hear from you, sir.

STATEMENT OF MAYOR F. EDWARD VANDIVIER, FRANKLIN, IND.

Mr. VANDIVIER. Thank you, Mr. Chairman.
Mr. ROSENTHAL. We are pleased that you could join us, sir.
I myself have not heard of Franklin, Ind.
Mr. VANDIVIER. I do want to thank you for this opportunity.
The awareness and recognition of a small midwest community of 12,000 is greatly appreciated. For, many times, our thoughts are that we are so little and that we have too little voice in our Federal Government in the maze of bureaucracy.

Our fiscal responsibilities are the same as New York or Cleveland or Chicago, except for the fact we do not rely on Federal funding.

Yes, we have requested Federal funds from EPA, from the Community Development Act, but we are not high enough on the list or the funds were expended before we got through the mass of forms and applications.

The cry of home rule is loud across this great Nation until one begins to falter, and then the federalism and the bureaucracies are expected to bail us out after our foresight was no longer than our nose.

It seems as if Franklin does not count as much as New York, Boston, Cleveland, and so forth, and yet, if you could take a census across the country, there are probably more small communities that are facing these responsibilities and, I believe, do a better job of it.

We have been turned down from EPA, for sewer construction funds and we went on it on our own, without Federal funds.

Actually, I believe it was cheaper.

The previous mayor just said that they had decreased police and fire protection.

We have increased our small police force from 15 to 19, our 11 firemen from 11 to 23, and added a new station.

We reduced local taxes.

I think probably there is a lot of mass exodus to the urban area, out of the metropolitan area.

When we asked for funds from the Community Development Act by being outside the city of Indianapolis, we get into a region where we were denied funds.

Yet, outside the region the funds were available to them.

I am not totally sure that the Federal revenue sharing fund is exactly the thing we want. It seems that we are adding an outside force that we no longer have complete control of.

We are not spending any of our Federal revenue funds for daily operations, but we are being forced into spending them for capital expenditures.

Mr. Rosenthal. How do you handle your financing? Are your problems in any way similar to those we have heard earlier?

Mr. Vandivier. Yes; they are very much, I think, except for the fact that we are a small unit of government and thus, we know what is going on all the time.

I did not bring counsels or charts today. I can understand that Chicago and New York would have some. It would be very hard for them to maintain the control that we do.

Yet, there is some lack of communication between their departments. I hate to think that they are so big that they cannot control them because the Federal Government is the same way.

I feel that there is a definite desire in the Federal Government to bring home some of the things that we desire and need so much.

Mr. Brown. You mentioned the problem of community development block grants.

I want to assure you that those of us who were very much involved in the passage of that legislation are similarly concerned. We seem to have plenty of funds in the 20 percent set-aside for the rural areas, but for communities which are within an SMSA, as you are in the Indianapolis SMSA, the discretionary funds just are not there.

That comes from three reasons really.

One was the whole harmless formula which was changed in the course of the passage of legislation primarily imposed by the Senate.

Second, we thought that there were a minimum number of urban colonies which could qualify under the criteria.

Third, the actual appropriations did not come up to quite what we had anticipated when we established the discretionary funds.

So, those three things combined meant that extra money going to urban colonies which takes in a lot of discretionary area with communities like yourself getting discretionary funds, the whole harmless and the lower level appropriation, meant that there wasn't any discretionary money within the SMSA's.

That has been remedied. We are asking for additional appropriations. There is even legislation in to earmark 5 percent of the 80 percent for metropolitan areas for discretionary funding for communities within an SMSA.

So, I don't want to be too discouraged because you have problems this time because our estimates and our anticipations proved to be faulty. We will correct that.

Once the program is in place, once you go through the whole harmless time of 6 years then the formula, I think, will work well. I think you will be quite satisfied with it.

Mr. VANDIVIER. Did you say within 6 years?

Mr. BROWN. That is when the whole thing is in place. There will be improvements along the way because legislatively we will change it to do something about funds for discretionary grants to communities within the SMSA's.

However, what I am saying is that, once it is in place, we will not have those problems.

So, what we need to do is to do something in this transition period.

Mr. ROSENTHAL. Mayor Maloney, how do you see the situation that Mayor Beame was describing inasmuch as you are a member of the National League of Cities?

Mr. MALONEY. As I indicated, I think that the overall theme that I was trying to get across was:

First. Certain cities have gotten involved in certain things that they probably should not have been involved in. They were forced into it because no one else was taking the leadership in these areas. It is obvious that many programs in which the cities are involved are worthwhile and address themselves to significant needs in the community. New York has certainly just come to the point where there is very little left. It is obvious, in my opinion, that New York City is a worthwhile city to save and that, unless they are going to get some help federally—whether it is through direct aid from the Federal Government, or making loans available or guaranteeing loans through other institutions, the basic question is whether New York City is worth saving or not. That question has to be addressed.

If you look at New York City, as Mayor Beame said, it is the capital city of possibly the world. It has got the U.N. in it. It possibly has got the finest art collection, the finest level of culture, business activities unequaled in the world, and so forth.

So, the basic question is, Should New York City survive?

Certainly, I think that we have to answer, "Yes."

Second. How we are going to do it?

There are a number of methods that have been talked about. One will have to very carefully examine these various approaches. Mayor Beame is more able to discuss the specific programs that are acceptable to him or that he thinks are in the best interest of New York. Certainly, they may be different than in other communities where the problem is somewhat different.

Mr. ROSENTHAL. When you say that you cut the cost of many of these services, how did that affect the delivery services?

Mr. Maloney. Let me say this.

As soon as I was elected, we set up a budget management review team which analyzed the operations in each department. We wanted to see what the city was doing because, obviously, you get so tied up firefighting in the day that you don't review what cities have done.

Historically, a lot of things have been done which cannot be justified from a good management standpoint; and they go on.

So, we evaluated and found that we had five-man garbage crews. Most communities across the country only had three, so the obvious conclusion was to cut them off.

This had been recommended by two previous administrations, but nothing had been done.

I cut back. My house was picketed; my office was picketed. We had quite an interesting time, but we were able to make sure that we had frozen enough positions in other departments so that we could phase those people into them who would be affected by the layoff.

We cut back 11 percent with our firefighting department. In 1921, the city assumed all of the volunteer fire companies just because they were there, not because there was anyone who studied how many firefighters were needed, how many engines were needed, and how many locations were needed.

We worked with the Rand Corp. in New York which computerized our response time and how long it would take us to get to any section of the city. So, in an intelligent way we approached the problem, and ended up with another strike which was an emotional situation.

I was accused of having babies burned, and they laid caskets in front of my office; but it was obvious that we were involved in something that had to be done.

In some of the other departments, we were fortunate that some of the issues had not been so controversial, but in analyzing carefully the various departments we were able to determine what could be accomplished in a day, a week, and a month.

The cutbacks which we made were those which were prudent and which enabled us, in some instances, to increase the level of services because we knew exactly what kind of task had to be done in a short period of time.

I don't think you can go in overnight. You have to carefully analyze and study these departments to find out what they should be achieving, where the waste is, and certainly make sure that these things can be achieved with no loss of services.

You can do this over a long period of time; you cannot do it overnight.

Some of the negotiations that you go through are somewhat traumatic. They oftentimes don't win a lot of political friends, I might add. But, it is a situation where I represent a city that has made a lot of changes, and some of them have been very difficult.

At the same time, we are running departments as efficiently and as effectively as we think they can be run. Some we are still working on, and there will be controversies over those I am sure in the weeks and months to come.

We still have a disadvantaged position in attracting businesses in to provide job opportunities for people. The question comes down to whether the Federal Government wants to constantly keep going into manpower programs or would it rather see local governments able to stimulate economic activity that jobs are going to be produced there.

This is the question. The kind of policy decisions that we deal with were so far down the line that we end up making policy decisions to increase local taxation that pushes businesses out and so the job opportunities for poor people who live in the cities are so few that we intensify the problem.

Mr. ROSENTHAL. It is a vicious circle unless it is reversed.

Mr. MALONEY. That is exactly right. Most of it is as a result of Federal policy.

Mr. BROWN. Mayor Maloney, we thank you for your statement. I think it is an excellent one.

You have analyzed the problem very well, particularly with regard to the causes of the problem.

What does the State of Delaware do to attempt to in some way ameliorate this tremendous difference that you show on your chart in table B with respect to property taxes, school taxes, wage taxes, etc., so that there is such a great advantage to locate outside the city rather than in the city?

Do you have a commuter tax, for instance?

Mr. MALONEY. We have a wage tax.

Of course, I would like to point out that this wage tax puts us at a competitive disadvantage. We get money from the suburbanites who come into work, and from an economic standpoint I think we can justify that as a fair levy because they are paying for services that are delivered to them.

But, on the other hand, if we are trying to attract business in, and they see that levy there; or if the potential residents see that levy of 1¼ percent tacked on to their paycheck, then they don't like it.

So, we can say that from a municipal user standpoint that this is equitable. But for putting your city into a competitive position, it hurts you very badly, and I have the businesses who, instead of expanding in the city, buy land outside and build new operations outside the city. They are eroding our tax base and not providing job opportunities inside the city.

I attempted to get our State legislature to give us some transfers that would enable us to even reduce our wage tax. Some of the things that I mentioned in the statement, like trying to get the State government to assume the tax-exempt status that we give to hospitals which provide a regional and even a State function, I attempted. We wanted the State to pay the million dollars that we forgo in property taxes because most of the users are suburbanites.

The same thing is true with public housing units, especially for the senior citizens where 30 percent of them never even live in the city and they are now occupying the housing projects that are built for senior citizens.

It is an obvious inequity that just because you live in the city you have to provide the police protection, and fire protection, et cetera, for those units; and many other services.

It is obvious that senior citizens are going to want to live in the city because there is certainly closer proximity to shopping, medical facilities, public transportation. So it is obvious that these concentrations are going to exist.

But if the cities are the only ones picking up that bill, then we are obviously going to have to keep raising taxes because somebody has to pay for those services. As we keep doing this, we are driving more businesses outside the city, more job opportunities, and, let's face it, the things you have left in the cities now are the white collar kinds of jobs. These people often commute.

The poor people who used to get the industrial jobs are finding your major industrial plants moving outside of the cities. Many of them are moving to the South, and therefore the poor people—the ones you need to get the jobs for—are unable to find any jobs. So, the result is that we are paying fortunes in welfare and unemployment compensation and other kinds of transfers in our cities because we are not doing what we should be doing in my opinion to make cities a better place for these kinds of opportunities to exist .

Mr. BROWN. Thank you very much once again. I want to commend you for your statement.

Mr. ROSENTHAL. I want to thank both of you.

We have to adjourn now because the House is in session.

This has been very enlightening this morning. We will have to pursue this matter further.

I want to congratulate both of you for constructive statements.

The subcommittee stands adjourned.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

FEDERAL RESPONSE TO FINANCIAL EMERGENCIES OF CITIES

WEDNESDAY, JUNE 25, 1975

House of Representatives,
Commerce, Consumer,
and Monetary Affairs Subcommittee
of the Committee on Government Operations,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:35 a.m., in room 2203, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Robert F. Drinan, Elliott H. Levitas, David W. Evans, Edward Mezvinsky, and Willis D. Gradison, Jr.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Wanda J. Reir, counsel; Doris Faye Taylor, clerk; and Lawrence T. Graham, minority professional staff, Committee on Government Operations.

Mr. Rosenthal. The subcommittee will come to order.

Today, the subcommittee continues its hearings on the operations of the Federal Government as they relate to the financial emergencies facing an increasing number of American communities.

As we stated earlier, the issues to be examined by the subcommittee include the following:

What is the proper role of the Federal Government with respect to the financial emergencies of our communities?

To what extent do Federal monetary and fiscal policies contribute to the money crisis in our cities?

Is Federal tax exemption for State and local securities the most efficient method of financing municipal debts?

Are the examinations in order policies, practices, and procedures of the Federal bank and the regulatory agencies efficient in terms of identifying the ways in which the loan and investment activities of banks affect the fiscal conditions of our cities and communities?

Are the operations of the Federal Reserve Board in control of the currency and the Federal Deposit Insurance Corporation attuned to the needs of our cities and the complex interrelationship between the cities and the financial communities?

The monetary policy of the Federal Reserve Board is directly related to the recession our economy is struggling to escape from and the unemployment that pervades every town and city and community. The bank regulatory policy of the Board with its well-publicized emphasis on capitalization adequacy has caused banks to retrench in their lending policies to the detriment of the consumer's business and the city.

To minimize the human distress that is incurred when a city is forced to precipitously cut back on its social services, minimizing the destruction of our financial markets, and ultimately to minimize the extent of Federal intervention in local governments, some lender of last resort facility for municipalities must be established.

Until that time, the Federal Reserve System, which is the central bank of the United States, I believe must recognize its responsibilities as the Nation's ultimate lender and develop the capacity to act upon that responsibility.

We are honored and pleased this morning that the Vice Chairman of the Federal Reserve Board, Mr. George W. Mitchell, is with us to speak on behalf of the Federal Reserve Board.

Governor Mitchell, we know that you have a prepared statement. We are pleased to hear from you.

STATEMENT OF GEORGE W. MITCHELL, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Mitchell. Thank you. Mr. Chairman, I am pleased to appear before you today to present the Board's views as to the use of Federal Reserve credit facilities in providing emergency assistance to financially troubled cities. I want to state at the outset that we interpret the System's present powers to engage in such lending operations, except as member banks are involved, to be quite narrowly circumscribed by law.

The recent financing difficulties of New York City provide a case in point. These difficulties cumulated rapidly during this past winter and spring, and reflected the growing reluctance of private investors to purchase the city's short-term note issues. Since the city already had a very large amount of short-term debt outstanding, and was incurring a substantial current operating deficit as well, any inability to issue new debt raised immediate problems in finding the cash to pay off maturing obligations and meet the city's current bills. In searching for alternative means of resolving the developing financial crisis, there were at times suggestions that the Federal Reserve might be a possible source of credit in its role as an ultimate source of liquidity to the economy. However, no application for credit was received from the city, either at the Federal Reserve Bank of New York or the offices of the Board of Governors.

If a formal request had been received by the Federal Reserve for the emergency credit accommodation of New York City under the circumstances that had prevailed, however, I am obliged to state that, in my judgment, the Federal Reserve would have had to turn it down. The city had not fully exhausted possibilities for State assistance, and its basic need for credit did not appear to be of a temporary character since no near-term means of repayment—while continuing to provide the city's basic services—appeared to be at hand.

Direct extensions of emergency credit to institutions that are not members of the Federal Reserve System can be provided under either paragraph 3 or paragraph 13 of section 13 of the Federal Reserve Act. Paragraph 13 provides that any Federal Reserve bank, subject to such regulations as the Board may prescribe, may lend to any individual, partnership or corporation on promissory notes secured by direct obligations of the U.S. Government or an agency thereof. Loans under this paragraph are limited to 90-day maturities. Unless an entity in need of assistance possesses large amounts of direct Government obligations, the ability of a Reserve bank to provide credit assistance under this paragraph is very limited.

Paragraph 3 of the act empowers the Board of Governors, in "unusual and exigent circumstances" and by an affirmative vote of at least five members of the Board, to authorize the Federal Reserve banks to make certain types of direct loans to individuals, partnerships or corporations. Paper discounted by Federal Reserve banks under this paragraph must be of the "kinds and maturities made eligible for discount for member banks under other provisions" of the Federal Reserve Act. This means, among other things, that the paper may not have a maturity of more than 90 days at the time of discount. The paragraph further provides that the paper shall be "endorsed or otherwise secured to the satisfaction of the Federal Reserve bank," which the Board has construed to mean that a Reserve bank should ascertain that the security offered is adequate to protect the Reserve bank against the risk of loss.

In light of these restrictions in the law and the background as to the intent of the law, the Board has concluded that, in considering the extension of emergency credit to particular borrowers, the following conditions must be met:

(1) Unusual and exigent circumstances exist;

(2) Potential borrowers have exhausted other sources of funds;

(3) The borrower is solvent and has adequate collateral;

(4) The borrower's need is for short-term accommodation and its basic financial position will permit early repayment; and

(5) Failure to obtain Reserve bank credit would have a significant detrimental economic and financial impact on the surrounding area, the region, or the Nation.

These criteria highlight the essentially low-risk and temporary character of System emergency lending, as well as the general economic purpose behind it. Such lending is intended primarily to provide liquidity. Though short-term needs of this type can develop among either large governmental units or business enterprises, in most cases the need can be accommodated without relying directly on the Federal Reserve simply by turning to commercial banks—who will rely on their own or Federal Reserve resources—to extend the needed credit. When this is not possible, as seemed to be the case with New York City, it is likely that the difficulties encountered in the private credit markets reflect more fundamental credit-risk problems and that temporary credit accommodation will not be sufficient to correct the situation.

In addition to the emergency lending powers contained in section 13 of the Federal Reserve Act, section 14(b) authorizes the individual Federal Reserve banks to purchase and sell obligations of State and local governmental bodies. The act requires that these governmental obligations mature in no more than 6 months from date of purchase and that they be issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues.

The 14(b) authority had its origin in the original 1913 version of the Federal Reserve Act. The House report on the act indicated that the provision was designed to open an outlet through which idle funds of Federal Reserve banks could be profitably channeled and to provide a means to enable Federal Reserve banks to make their discount rate effective in the market at those times when member bank borrowing was slack. There is nothing in the act or its legislative history to indicate that this authority was intended to be used as a channel for financial assistance to public bodies. Moreover, the authority has not been used since 1933, since enactment of section 10(b) permitted the Federal Reserve to advance credit to member banks on the strength of their own promissory notes, as well as through the discount of eligible paper. Given this background, the Board does not believe that section 14(b) contemplates the purchase of municipal obligations as a means of aiding financially distressed communities.

In view of these existing constraints on System emergency lending, it may be asked whether it would be desirable to legislate broader powers that would permit Federal Reserve accommodation of financially distressed communities. While the Board has not considered any specific proposals toward this end, I would strongly caution against any proposals that would provide direct access to central bank credit by hard-pressed governmental units. My reasons for reaching this judgment are as follows:

First, the critical issue for particular municipalities is how governmental functions and sources of revenues are dispersed between it and the State government. Prospective sources of funds must be commensurate with the projected costs and expenditure programs in order to balance out over the longer run. Access to a source of temporary credit will not help to achieve such a balance, and it may tend to defer or prevent the remedial actions that are necessary, difficult as they may be.

Second, central bank involvement in providing temporary credit accommodation to State and local governmental bodies will necessarily require that standards be set determining which localities will be eligible or ineligible for credit accommodation. This would involve the System in making credit judgments on the finances of numbers of State and municipal governments, thus subjecting the Federal Reserve to intense political pressure to make exceptions for this city or that because of special circumstances. Moreover, the need to exercise administrative discipline over borrowers in order to assure timely repayment would tend to draw the System into political issues of local budgetary policy. A central bank, in our judgment, should leave this issue to other agencies of the Government.

Third, increased access to central bank credit by municipalities suffering some degree of financial distress could lead to similar urgent demands for credit by other kinds of borrowers. If central bank credit is extended to our cities, for example, why not for a host of other purposes, such as the immense investment that will be required to achieve energy independence? A proliferation of demands for credit from the central bank would drastically change the character of the assets of the Federal Reserve System, from prime paper of highest quality to an assortment of soft loans and, in the process, severely damage the Government's access to financing. It could undermine our ability to control the volume of bank reserves and hence the supply of money. In the extreme, the result could be a debasement of the Nation's money and ruinous domestic inflation.

For these reasons, if your committee should conclude that the financial pressures on key municipalities requires the provision of special Federal financing assistance in the period ahead, the Board would strongly urge that this be done through a separate facility rather than the Federal Reserve. Federal moneys or credits would still be expended in any such venture, but it would not involve the use of high-powered central bank funds. Such a separation would thus leave the Federal Reserve free to pursue its other responsibilities for monetary and bank regulatory policies, which are difficult enough in themselves.

I would urge caution, however, even in proposing the establishment of a special Federal financing facility to assist with the financing needs of our State and local governmental bodies. Such a facility must have sufficient oversight powers to permit it to play an effective role in correcting the fundamental financial problems of client communities, if the Federal assistance is to be productive. This would be bound to create a Federal presence in local issues of taxation and spending, a varied and shifting political and social terrain indeed.

In the spirit of our traditional system of separation of powers, it may well be better to leave local problems to local solutions. The special program of financial assistance which was developed for New York City at the State level through the formation of a new agency—the Municipal Assistance Corporation—is an illustration of State-local resourcefulness. The corporation is authorized to provide up to $3 billion in credit to the city and, as it does so, valuable time will be gained in which the city can take the steps needed to restore its credit standing with the private investment community. I hope that the city's actions will soon make it possible to carry on needed refinancing and other debt operations in the normal manner.

Mr. ROSENTHAL. Thank you very, very much, Mr. Chairman.

How does the tight monetary policy engaged by the Federal Reserve in 1974 relate to the unemployment we are presently experiencing?

Mr. MITCHELL. Monetary restraint operates through a tightening on the supply of credit available to the economy, but there are many other factors which are involved in this recession: an overaccumulation of inventory, speculation in inventories, and overinvestment in housing facilities of one type or another, a depreciation of the dollar abroad, an oil crisis, and so forth. These are all factors which compound the economic situation, and, I think, eventuated in this recession.

Mr. ROSENTHAL. The Fed did have a tight monetary policy, did it not?

Mr. MITCHELL. Yes, it did. That is correct.

Mr. ROSENTHAL. And, in a sense, it did relate to the unemployment situation as we now find it?

Mr. MITCHELL. Yes, I think that is correct.

Mr. ROSENTHAL. What importance—if any—does the Board attach to the unemployment that results from the Federal monetary policies?

Mr. MITCHELL. The Board is seriously concerned with the level and the duration of unemployment. It feels that it is important to have a set of fiscal and monetary policies that will lead to a reemployment of people who are out of jobs.

Mr. ROSENTHAL. During the time that you had these matters—and, particularly, this New York City matter—under discussion did the Board as a group take into consideration the social costs in human suffering that would result from precipitous cutbacks in social services in New York, or any other city, that would be necessarily undertaken to balance its budget out?

Mr. MITCHELL. Mr. Chairman, the board is not in possession of enough facts about the New York City situation to make a judgment as to what ought to be done in New York in order to correct the problem that presently exists there.

The financial problem is one in which New York City has about $12 or $13 billion in debt of which about $6 billion is short-term debt.

That is a very substantial load of debt and one that is very difficult to roll over unless you have an excellent credit standing—and New York City's credit standing has been deteriorating.

Mr. ROSENTHAL. I understand.

I was just wondering if in all the discussions that the Board had—I am sure you had discussions on such a huge problem—did you discuss to take into account the social costs which would result from a reduction in services which were necessary to lead to a balanced budget?

Mr. MITCHELL. If there were a means that we could see by which we could have alleviated that situation, I think we would have done so. However, we do not see any way of rendering effective service under the statute and under the constraints applicable to the Nation's monetary authority.

It is really a job for somebody else.

Mr. ROSENTHAL. That is what the committee will eventually have to determine.

Mr. MITCHELL. Yes.

Mr. ROSENTHAL. Is the Federal Reserve concerned with bank capital positions and how do they relate to the bank and financial soundness?

Mr. MITCHELL. The Federal Reserve has been concerned with bank capital positions because, as you know, banks do not invest their money: they invest their depositors' money. The security of those depositors is partially protected by the Federal Deposit Insurance Corporation and partially protected by the level of equity capital in the banks. That equity capital has been shrinking. It has impaired the banks' ability to secure more funds in the market. Again, the banks have the same problem of entering the market that anyone else has. They have to have a strong position in order to get people to invest in their securities and in their debts.

Mr. ROSENTHAL. And it is in the interest of the Federal Reserve Board and the System that the banks maintain satisfactory capital levels?

Mr. MITCHELL. That is correct.

Mr. ROSENTHAL. What is in the terminology of your community the A-B-C ratio?

Mr. MITCHELL. There are many types of formulas to determine the adequate capital of a bank. That A-B-C ratio is one of them.

Mr. ROSENTHAL. It is one element?

Mr. MITCHELL. It is one of them. It is one of the methods.
Mr. ROSENTHAL. What does it mean? Adequate capital?
Mr. MITCHELL. The formula is not that simple.
Mr. ROSENTHAL. Is an A–B–C ratio of 1 an accepted safe ratio?
Mr. MITCHELL. It is not a ratio that I use: So, I cannot answer.
Mr. ROSENTHAL. What I am really trying to lead up to is, is the capital position of the leading New York banks completely satisfactory for the Federal Reserve?
Mr. MITCHELL. Some, yes.
Mr. ROSENTHAL. Let me just run down a few. I hope you can answer these from the top of your head.
Mr. MITCHELL. I don't think I can. I will try.
Mr. ROSENTHAL. All right. Let us try.
How about the First National City Bank?
Mr. MITCHELL. I think the First National City Bank would like to add to its capital and I would like to see them do it.
Mr. ROSENTHAL. How about the Chase Manhattan Bank?
Mr. MITCHELL. The answer would be the same.
Mr. ROSENTHAL. The Morgan Guaranty Trust Co.?
Mr. MITCHELL. I think Morgan Trust has a stronger capital position.
Mr. ROSENTHAL. The Chemical Bank?
Mr. MITCHELL. We would like to see them add to their capital. They withdrew an issue which would have added to their capital this last spring.
Mr. ROSENTHAL. The Chemical is the weakest of all those I have mentioned so far; isn't it?
Mr. MITCHELL. I don't believe I should answer that question.
Mr. ROSENTHAL. You are the chief regulator among the high ranking people on the Board?
Mr. MITCHELL. The regulatory authority is divided between the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Reserve Board.
Mr. ROSENTHAL. But within the Board, you are on the top of the heap of the regulators; isn't that correct?
Mr. MITCHELL. I don't think I should say that either.
Mr. ROSENTHAL. Assuming the natural modesty that we all have.
Mr. MITCHELL. Very well.
Mr. ROSENTHAL. We could attribute that achievement to you.
Mr. MITCHELL. Attribute it if you like.
Mr. ROSENTHAL. The Bankers Trust Co.?
Mr. MITCHELL. I think that bank should have more capital.
Mr. ROSENTHAL. The Irving Trust Co.?
Mr. MITCHELL. I don't know.
Mr. ROSENTHAL. The Midland—that is, the Marine Midland Bank in New York?
Mr. MITCHELL. I think they should have more capital.
Mr. ROSENTHAL. The National Bank of North America?
Mr. MITCHELL. I don't know.
Mr. ROSENTHAL. The Bank of New York?
Mr. MITCHELL. I don't know.
Mr. ROSENTHAL. I sense, even from the measured tones of your responses, that you and the Board would like these banks to be in a better financial condition than they are?

Mr. MITCHELL. No; regulators are never 100 percent satisfied with the financial condition of a bank. It can always be better than it is.

However, the New York banks as a group are in a strong position.

Mr. ROSENTHAL. Are what?

Mr. MITCHELL. Are in a strong position to provide loan services for their customers.

We would like to see them in a stronger position.

Mr. ROSENTHAL. Of all the banks which are listed only one you seemed satisfied with; that was the Morgan.

Mr. MITCHELL. In looking at banks I would like to see them all stronger than they are, but I think they are all strong banks.

Mr. ROSENTHAL. The Chemical you seemed to hesitate more about than the others?

Mr. MITCHELL. I was trying to recall what happened to the financing which they projected. The financing was not sold, it was withdrawn.

Mr. ROSENTHAL. What I would like to know, Mr. Chairman, is what would happen to the capital positions of these banks if the $1.25 billion in the New York City debt would go into default?

Mr. MITCHELL. If the $1.25 billion of the New York City debt were to go into default, it would have very little effect on asset quality of the New York banks.

Bear in mind that the banks in the Nation hold $100 billion of municipal debt.

Mr. ROSENTHAL. $100 billion?

Mr. MITCHELL. $100 billion of State and municipal debt.

Mr. ROSENTHAL. In their name or by fiduciary capacity or what?

Mr. MITCHELL. No, this is in their portfolio.

Bear in mind that, when you talk about banks investing, you seem to be talking about the banks' money. It is not the banks' money. One out of $20 or one out of $18 is the bank's money. The rest of it is the depositors' money.

Thus the bank's own portfolio of securities and loans are the assets backing up their liabilities in the form of deposits. They hold $100 billion of municipal and State debt, which is about 13 percent of their total loans and investments. U.S. banks hold about an equivalent amount of Federal Government securities.

Mr. ROSENTHAL. In all the banks of the United States, 13 percent of their total investments is in local governmental securities?

Mr. MITCHELL. State and local.

Mr. ROSENTHAL. Yes; that was what I meant.

My question is, what would happen to the capital position of the New York banks which we are not so happy with anyhow, if the city went into default?

Mr. MITCHELL. New York State banks have about $130 billion of loans and investments. So, you are talking about $1.2 billion? New York City debt is not held only in New York City banks; much is held in banks all over the United States.

Mr. ROSENTHAL. I just want to know what the answer is. I don't want to argue with you.

If the city defaulted, it would virtually have no effect on the New York City banks or on any banks anywhere?

What would be the effect?

Mr. MITCHELL. A default is not the same as a loss. It might not have any effect or it might have very little effect.

It would have a far more serious effect on the city of New York than it would have on the banks.

Mr. ROSENTHAL. Right now, we are looking into the adequacy of Federal regulatory bank examination procedures.

Maybe you are doing well and maybe you are not doing so well; that is what we are going to try to find out.

We can only find out by reviewing the facts.

Mr. MITCHELL. All right.

Mr. ROSENTHAL. Your measured opinion is that, if the city defaulted, that is, if the city did not pay what it is supposed to pay, it would have what kind of an effect on the banks of New York City, on the banks of New York State, and on the banks in the Nation?

Mr. MITCHELL. I think it would have a minimum effect.

Mr. ROSENTHAL. A minimum effect?

Mr. MITCHELL. That is correct.

Mr. ROSENTHAL. Let us examine that.

What is the Federal Reserve's responsibility with regard to the financial market's stability?

Mr. MITCHELL. The Federal Reserve's responsibility is basically to keep the banking system in a healthy, viable condition.

To keep Government security markets in a healthy, viable position, the Government is having to sell a great lot of debt in the next 6 months. It cannot sell it in a demoralized market. That is vital. That is essential.

Mr. ROSENTHAL. You said that, if the city defaulted, it would have a minimal effect on the banking stability in the community.

If the effect would be more serious, do you think that the position enunciated in your presentation would be different?

In other words, part of the consideration of the Board was that it would be negative because it felt that the impact would be minimal.

If the impact would be significant, do you think the responsibility increases proportionately?

Mr. MITCHELL. It is conceivable that some banking institution could have a disproportionate amount of defaulted debt and that bank might have difficulties, but taking banks as a whole, I don't think I visualize that.

Mr. ROSENTHAL. How much money did the Board put into the Franklin National Bank?

Mr. MITCHELL. We lent the Franklin National Bank up to $1.7 billion, and incidentally we got our money back. It was a member bank.

Mr. ROSENTHAL. Were you involved in the Security National or was that the Comptroller of the Currency?

Mr. MITCHELL. That is a national bank.

Mr. ROSENTHAL. You were not involved in that one?

Mr. MITCHELL. No.

A national bank is supervised by the Comptroller.

It was taken over by Chemical, which is a State member. We made some loans to Security. It is a member bank.

All member banks are eligible for loans from the Federal Reserve, but the examination of the bank is divided. If it is a national bank, it is examined by the Comptroller, if it is a State member bank, it is examined by the Federal Reserve.

Mr. ROSENTHAL. How about the bank in San Diego? I don't recall the name of it.

Mr. MITCHELL. The San Diego National Bank. It is a national bank.

Mr. ROSENTHAL. How much did you put in there?

Mr. MITCHELL. I don't recall. It was minimal.

Mr. ROSENTHAL. Mayor Beame testified before this committee on Monday. He suggested that part of the need for borrowing was to cover expenses incurred by Federal programs in which revenue sharing money would subsequently come later in the year.

In other words, it was in a sense an obligation insured by Federal repayments. That would meet the Board's guidelines, wouldn't it?

Among the guidelines listed on page 3?

Mr. MITCHELL. They need the flow of Federal aid in order to operate. They could not divert it to repayment of debt money and continue to operate.

Mr. ROSENTHAL. Is there anything specifically in either regulation A or E which prevents or precludes the Board from assisting a city like New York in financial difficulties?

Mr. MITCHELL. The only way in which we could assist them by loans were enumerated in my statement.

In other regulations I don't believe so.

Mr. ROSENTHAL. I wonder if we could go to page 3 of your statement?

One of the things we are concerned about—I, naturally coming from New York City, am acutely aware of the problems in the city, but we do have reports from other communities: Cleveland, Detroit, and many other cities, saying that they are leading down the very path of financial difficulties which New York is having. It may well be that it is the time for the Board to take a new look at this area of responsibility so that they can meet what we perceive—or, at least, what I perceive—as a national potential problem.

On page 3, could you tell us on each of those categories in: (1) How do you see the New York situation with these criteria?

Mr. MITCHELL. All right.

No. 1, unusual and exigent circumstances exist; that is true.

Mr. ROSENTHAL. So, we can put a checkmark against that number?

Mr. MITCHELL. Yes.

The Board did not take it up just in this fashion, but that would be true without any doubt.

No. 2: "Potential borrowers have exhausted other sources of funds." That seemed to be the case, except for this "Big MAC."

No. 3: "The borrower is solvent and has adequate collateral." The borrower in this case does not have adequate collateral.

Mr. ROSENTHAL. Would any municipal community have adequate collateral?

Mr. MITCHELL. I think that is doubtful.

Mr. ROSENTHAL. What is adequate collateral when you are talking about an institution of government?

Mr. MITCHELL. These rules are written primarily for banking and other business institutions, not for government.

Mr. ROSENTHAL. I know.

That is why I am trying to find out whether a new set of rules could be written for communities.

Mr. MITCHELL. I suppose that security based on the anticipation of tax receipts might be regarded as an adequate collateral.

Mr. ROSENTHAL. That would not be in the sense of bending of this rule but it would be a modification of the system under the circumstances.

Mr. MITCHELL. But sources of that type were not available either.

Mr. ROSENTHAL. So we check that also, but with a question?

Mr. MITCHELL. That is right.

No. 4: "If the borrower's need is for short-term accommodation and its basic financial position will permit early repayment." That was not so.

No. 5: "Failure to obtain * * * would have——." Yes; it would meet that criteria clearly.

Mr. ROSENTHAL. So, we miss out on 4.

Mr. MITCHELL. On 3 and 4.

Mr. ROSENTHAL. Member banks borrow continuously. Do they have adequate collateral?

Mr. MITCHELL. They have adequate collateral. They ordinarily use Government securities for collateral.

The banking system as a whole has about as much in the way of Government securities as they have in State and local securities.

Mr. ROSENTHAL. But member banks don't necessarily repay it because they are continually reborrowing to make the payments.

Mr. MITCHELL. No. If the bank is in serious trouble, it will borrow for quite awhile, but generally, the borrowing by member banks is for a limited period of time. It is a temporary accommodation.

It is not like a Home Loan Bank Board which makes, in effect, capital loans to its members.

Mr. ROSENTHAL. I would really want to know, Mr. Chairman, whether you personally think whether the same stringency of rules should apply to communities which run the social and governmental services, as you apply to a profitmaking bank and to a corporation?

Mr. MITCHELL. The rules might have to be somewhat adapted, as you suggested. However, you have to have assurance of repayment in order to borrow.

Mr. ROSENTHAL. Let us assume that the city went under and could not repay, does that cause any convulsive problems for political and financial institutions in the United States?

Mr. MITCHELL. I think it causes a convulsive position for the city of New York—to use your language—because New York is so heavily in debt that, unless someone contrives a bankruptcy proceeding applicable to a city, I don't see how they can avoid coming to the market and satisfying the demands of people who invest their money.

Mr. ROSENTHAL. Should the Federal Government be the lender of last resort?

Suppose they cannot make it in the commercial capital market, shouldn't the Federal Government take cognizance of that fact?

Mr. MITCHELL. Maybe Congress should do that. As I said in my statement, however, I believe that this should be left to the State and local governments to work out.

Mr. ROSENTHAL. Let me go back to one of your statements. You said, "to leave the local solutions to local governments."

In the city of New York—I don't want to make this a city colloquy—however, there are 1 million people on welfare, there are 1 million aliens, and so forth. Much of this responsibility comes from Federal inaction, Federal default, and Federal failure.

The city has already assumed the Federal responsibility. It is now seeking a commensurate repayment.

Mr. MITCHELL. Mr. Chairman, in the late twenties when I was living in Chicago, there was reassessment for tax purposes of all the property in Cook County. For 2 years, 1928 to 1930, there were no taxes collected in the city of Chicago or in the county of Cook from the property tax, and that tax was in essence their only source of revenue.

This situation was a desperate one. But it was solved by community participation in methods of meeting payrolls and providing services. It took a massive effort, but Chicago was able to make it. Cook County was able to make it.

That was followed by another 2 or 3 years in which tax collections were dismal.

That brings one right up to the RFC in 1933, but the problem appeared in 1928. Until 1933, remedial action was by the State and local governments. It was accomplished

Mr. ROSENTHAL. You see these situations as comparable?

Mr. MITCHELL. Yes; I do.

Mr. ROSENTHAL. You don't think that the times have changed since that period of time?

Mr. MITCHELL. Of ocurse, the times have changed. However, all I am saying is that the pattern of responsibility between the State and local government and the role of the Federal Government has not changed that much.

The Federal Government is a larger participant in local finances than it was then, obviously.

Mr. ROSENTHAL. Had Chicago at that time drawn the 1 million illegal aliens or 1 million people on welfare from other parts of the country?

Mr. MITCHELL. They were absorbing a lot of unemployment in the early thirties.

Mr. ROSENTHAL. Anyway, would you personally favor a Federal-municipal guarantee corporation to insure, for example, as the FDIC insures bank deposits, the debts of State and local municipalities?

Mr. MITCHELL. I would not want to answer that one without giving it careful thought.

Mr. ROSENTHAL. Congressman Evans?

Mr. EVANS. Mayor Beame the other day stated that there was a need to find the means to protect the city from economic panic—to prevent a run on the credit—just as there are laws to protect financial institutions, such as Franklin National.

Would you care to comment on that?

Mr. MITCHELL. It would be desirable to protect people or State and local governments against these exigencies, but I think that the New York problem has been worsened because of the city's financial practices. It has now gotten itself into such a serious borrowing problem that I don't know whether there is a way out unless the State is able to come up with something in addition to "Big MAC." "Big MAC" perhaps can keep it going for a while.

Mr. EVANS. How long do you think it will keep New York City going?

Mr. MITCHELL. I would say that, if the city were able to adopt some basic remedial measures, "Big MAC" might be an adequate intermediate measure.

Mr. EVANS. You are assuming that it has to adopt some measures.

Mr. MITCHELL. Yes; I think it has to. I believe the State also has some responsibilities.

I was director of finance for the State of Illinois when Adlai Stevenson was Governor. We had to face this same issue of financing the cities; not, however, in desperate straits like Chicago faced in 1928.

The problem there is one of what I call "redistribution" functions of Government—education, welfare, and health.

The policy we attempted to articulate was that those functions ought to be moved to the financial support of the State and Federal Governments.

I think that is part of the answer in New York. The city of New York is trying to assume too much in the way of responsibilities for educational, health, and welfare facilities.

I should not be offering these pronouncements because I am not active in that field any longer, but this is the way it seems to me from my background.

Mr. EVANS. Do you see any cause in New York City's present problems resulting from some of the past tight money policies of the Federal Government?

Mr. MITCHELL. No.

The financial resources of State and local governments are primary sales taxes or property taxes. They are relatively secure against something like that. The sales tax responds promptly to changes of this sort.

If the property taxes assessment were kept up, they would too.

Mr. EVANS. They are insulated from tight money policies?

Mr. MITCHELL. Relatively, compared to the income tax which is very volatile, whether corporate or personal income tax.

Mr. EVANS. Even over a long period of time?

Mr. MITCHELL. We are just talking about recession now and upsurge. The tax sources of State and local revenues tend toward yield stability.

I believe that, if you look at the function of the city as providing services of one character or another, you find it hard to see how cities can really support their social service activities—their welfare activities, their educational activities, and so forth.

I think that the trend is away from local support, of course, and toward a Federal support in those areas.

Mr. EVANS. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Congressman Gradison?

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Chairman, as you know, I have worked both sides of the street. I have been in the investment business for years and, also, I had a major role in dealing with the financing of a large city, Cincinnati, for a long time.

As you know, this city went through the depression of the thirties and maintained a triple A credit rate. So, I know these things are possible.

I was frankly disturbed by the testimony yesterday which seemed to say that the problems of New York City were caused, in no particular order, by the Federal Government, the State government, the commercial banks, the investment bankers, the bond rating services; everybody but New York City.

I was frankly disturbed because I don't really think that is so.

I would like to explore just what happened during the thirties. There seems to be an assumption here that, if the city defaults, it is going to float down the Hudson and out into the Atlantic Ocean.

I think that there are experiences of cities—I am not advocating default—which have defaulted, and counties which have defaulted during the thirties. I believe it would be a helpful exercise to talk about what happened in financial terms when this occurred.

Could you enlighten us on this at all, from your experience?

Mr. MITCHELL. I guess I am in the other camp by default. I think my views might be colored by my own experience.

When Chicago and Cook County went through all of those difficulties in the late twenties and early thirties, water bonds remained a good investment at low rates. The interest premium that has to be paid for default goes on for a generation after the default. I think therefore, that default is something that ought to be looked at pretty carefully before it is considered a viable alternative.

I would try very hard to avoid default if I could because I think——

Mr. GRADISON. I would, too.

The question I am asking is just mechanically what happens? Cannot the city continue to function?

Is it not required from that point on to get its income and out go into a balance and to trim the level of its services to the anticipated revenue?

Mr. MITCHELL. There are things worse than default; there is no doubt about that.

It is better to keep the essential city's services going than not to default if it comes down to that alternative.

In my opinion, however, default is a costly operation over the long term.

Mr. GRADISON. I am concerned that the involvement of the Federal Reserve in this matter as we are talking about it today could impair the ability of the Federal Reserve System to do its primary job.

Would you care to elaborate on that?

Mr. MITCHELL. We are very much concerned about that, also.

Our primary function is to provide a proper growth in the money supply.

We have a portfolio of about $90 billion. It is held in Treasury securities and agency issues, for the most part. There is a very small amount of loans to commercial banks. Thus almost all securities are essentially secured by the full faith and credit of the U.S. Government.

As I said in my testimony, I don't think that soft loans in that portfolio would be appropriate.

I believe that there is a better way in dealing with this problem than getting the Federal Reserve involved.

Mr. GRADISON. We were talking earlier about bank capital adequacy. My impression of the problem of bank capital is that in a period of inflation the capital investment has not been growing as rapidly as necessary to keep up with the inflation rate or, to put it in another way, with the level of reinvested profits which has not been moving up as fast as the level of inflation. The ability of banks to raise new capital has been impaired by earning levels as well.

What do you think is behind this problem of general concern about the level of bank capital and, if bank capital is not as high as we would like to see it, doesn't this impair the ability of banks to loan to all borrowers, not just State and local governments?

Mr. MITCHELL. That is right.

I believe that your suggested analysis of the reason for the reduction in the adequacy of bank capital is correct. Banks have not had as rapid growth in their retention of earnings as they have in their total footings. It has been difficult for them to get into the equity market for some time. They have even had difficulty this year in getting into the debenture market.

Incidentally, this is not unique to banks. Nonfinancial enterprises in the United States—utilities, and so forth—have had their equity position weakened.

There is a need for better markets to provide a better equity base for financial and nonfinancial business.

Mr. GRADISON. There was a suggestion the other day that the Federal Reserve had moved in some way to urge banks—member banks—to increase their financing so as to assist REIT's which were in financial difficulty, to meet some of their obligations.

This is a matter that was discussed at some length before a Banking and Currency Subcommittee of which I am a member and I think out of that has come some uncertainty about just what the Federal Reserve actually did.

After our hearing the other day I discussed this a little further informally with one of the other members of the committee, Mr. Maguire. I thought it would be helpful if we could bring this out and ask not only for any comments you might care to make about it but anything that might be added to the record, because there seems to be some differences of interpretation of what was said before that committee.

My recollection was that, whatever the banks were told or whatever was suggested to the member banks by the Board of Governors, was always done with careful phraseology about insisting on high level of credit worthiness for borrowers which has a direct bearing on what we are talking about here.

I think the issue is sufficiently important that it might be worth asking for comments now and any additional supplementary information for the record that would help us get the facts of just what happened in that case.

Mr. MITCHELL. I think that that episode is now being rapidly forgotten.

However, in the course of trying to inform ourselves as to the condition of member banks, we have made numerous inquiries about the progress of banks in dealing with problem loans in their institutions.

I believe that some of those inquiries have been construed in somewhat of a different way than we had intended them.

The banking system, I think, has performed an invaluable service in dealing with an unusually high number of troubled situations. Penn Central was one case which involved a large amount of bank lending. In the current economic environment, we have a variety of loans which have, for the time being, ceased to pay interest.

So, banks have had a problem working out these situations.

I think that most of this has been accomplished, but it has taken a considerable amount of time, negotiations and energy on the part of the member banks and other banks in the System to accomplish it.

As of now, I think that this is essentially behind us.

Mr. GRADISON. But the issue is not whether it is behind us. The issue is whether the Federal Reserve in any way instructed or urged or cajoled or encouraged or whatever the member banks to increase their lending or extending of existing loans which were outstanding to REIT's?

If so, what communications took place between the Board of Governors and the member banks with regard to that matter?

Mr. MITCHELL. There are a lot of people in the Federal Reserve System who might have commented on this issue. I don't know what everybody said.

I had, during this period of time, one telephone call. It was represented to me by my caller that he had been told by another bank that the Federal Reserve wanted his bank to extend additional credit and to renew a credit.

I said that the Federal Reserve had taken no such position and that no such order had gone out.

That is the only call of which I have personal knowledge.

However, I know it to be a fact that some bankers believed that the Federal Reserve was showing more than a casual interest in such situations.

Mr. GRADISON. Did the Board of Governors at any stage discuss taking action to urge the banks to extend existing loans or to increase their loans to REIT's, do you recall?

Mr. MITCHELL. I don't recall that that happened. This whole issue was discussed but not in those terms.

Mr. GRADISON. Not in those terms?

Mr. MITCHELL. No; not in those terms.

Mr. GRADISON. In other words, you did not concern yourself with——

Mr. MITCHELL. Otherwise, I would not have made the answer in the case I recited to you.

Mr. GRADISON. One final thing, Mr. Chairman.

I would ask unanimous consent that we include in the record the article in yesterday's Wall Street Journal which contrasts the financing of Buffalo, N.Y., and New York City. I think it may be instructive.

Mr. ROSENTHAL. Without objection, it is so ordered.

[The article referred to follows:]

[The Wall Street Journal, June 23, 1975]

Making Ends Meet in Buffalo

(By James Ring Adams)

Buffalo.—When Mayor Beame of New York City was making headlines earlier this year with announcements of layoffs which then amounted to about 3% of the city's workforce, Philip Cook, the budget director of Buffalo, the state's second largest city, was asked if he, too, was planning cutbacks.

"Most of our thinking is at the other end," he replied. "We're considering what services we absolutely can't cut and keep the city going. . . . We figure the water works is the most basic."

Buffalo may not really be this close to cataclysm, but it can match fiscal problems with New York City any day of the week. The problems obviously are different—New York has great economic advantages denied to Buffalo, and its sheer size puts it in a class by itself. But there are other differences that appear to be the result of deliberate political choice. New York has compounded its fiscal agonies by years of budget manipulation, while Buffalo has managed to survive in spite of acute economic deterioration by an austere approach to city finance.

In fact, it could be said that if Buffalo's approach had been applied to New York City 10 years ago, that metropolis would now be the darling of the credit markets, while if New York's attitudes had taken root in Buffalo that upstate city would long since have been a ward of the bankruptcy courts.

On strictly economic grounds, Buffalo is much the worse off. Unemployment in this aging, blue-collar city is 14.7%, the sixth highest in the nation. Industries have been departing steadily. The population—460,000 in the 1970 census—declined 13% in the '60s and assessed value of taxable property also dipped 3% in that period. Buffalo has an added problem in that it estimates 40% of its 41 square miles is taken up by tax exempt institutions, such as the five local colleges and two state university campuses.

A hefty rise in Buffalo's real estate tax rate last year, \$5.50 per \$1,000 of assessed value, pushed the city's tax delinquency rate to nearly 8%, the highest since 1939. The current tax rate, \$82.93 per \$1,000, is 20 cents higher than New York's. Fearful of growing foreclosures, Buffalo has frozen the tax rate and the upcoming budget projects a slight decrease in the \$86 million levy.

"AUSTERITY" AND "HORROR"

Like Mayor Beame who unsuccessfully sought a \$641 million tax and aid package from the state legislature to balance an "austerity" budget then put at \$12.7 billion, Buffalo's Mayor Stanley M. Makowski was asking Albany for an extra \$11.5 million for his \$244 million budget. However Mr. Makowski will have to wait for a decision until the legislators tie up all the loose ends on their much diminished aid package for New York City.

Like Mayor Beame, who at one point presented a "horror list" of payroll cuts totalling 20% of the city's 338,000 work-force, Mayor Makowski sent a memo to the State Assembly declaring that without further aid, Buffalo would have to cut its payroll by 20% to 25%.

Buffalo's cuts, however, would come after a five-year period in which the city steadily shrank its workforce from 6,500 to 5,200 (excluding the semi-autonomous city board of education). In the same period, New York City employment, as defined by a City Hall spokesman, has increased by nearly 50,000.

"We've been laying people off since 1971," says Mr. Cook. "In city government that's the only way to deal effectively with increasing expenses." (The 35-year-old budget director's conservatism might seem odd considering the fact that he was one of the founding members of the Students for a Democratic Society 10 years ago. He says he dropped out of SDS when it veered off on ideological tangents during the Vietnam war.)

For all its troubles Buffalo has done infinitely better than New York City in one crucial area—credit. "The city of Buffalo continues to enjoy the confidence of the investing fraternity," said Comptroller George D. O'Connell at a time when the public market had turned its back on New York City bonds and notes. In December, before the fiscal crisis, New York City had to swallow a 9.48% interest rate on a $500 million loan issue. But on April 1, Buffalo floated $56 million in notes at rates ranging from 6.9% to 5.87%.

One obvious reason, of course, is the much smaller volume of Buffalo's offerings, although Moody's reports that its overall debt burden is higher, measured against the estimated market value of the taxable property in the city, than New York's. The main source of investor confidence, therefore, must be the city's attitude toward its debt.

The city has shunned New York's primrose path of covering budget deficits by every conceivable gimmick. Buffalo does have a deficit problem—some $17 million this year alone and a cumulative total of $32.4 million by the end of next fiscal year. "Each year our cash problem comes at an earlier time and we're forced to resort to anticipation notes to get through," says James W. Burns, Buffalo's commissioner of finance and administration. But, he adds, the city retires its budget notes when they came due, rather than roll them over as New York City does. A large part of Buffalo's problem is its real estate tax delinquency; the upcoming budget reserves $5.6 million to cover it.

In fact, Mayor Makowski gives higher priority to reducing the deficit backlog than to avoiding layoffs. In his annual budget message, he told the Common Council that any state aid above his request should go "to continue the process of making our budget whole." A minimum of $10.4 million already has been appropriated. "We're trying to tackle this problem of wiping out the deficits and getting on a current cash basis," comments Mr. Burns.

This attitude partly comes from necessity. "Because we're smaller," says Mr. Cook, "We've never had any hope of controlling the state senate and assembly with a large bloc of assemblymen. . . . Our first reaction isn't to go to the state. On the other hand, I don't think there's a section of the Municipal Finance Law that doesn't have a special section for New York City."

In one instance, however, Buffalo has benefitted from an emergency ruling by the state legislature. This was to permit the city to keep pension costs out of the property tax. This was an aftermath of the "Hurd decision," a suit last year brought by Bradley J. Hurd, a retired businessman and president of the United Taxpayers League of Buffalo and Erie County. He charged that Buffalo exceeds its constitutional tax power in paying employe pensions and Social Security from sources other than the property tax. The state's highest court agreed.

Then another tax protester, Aurthr O. Pellnat, a typewriter repair man who runs the Schiller Park Taxpayers' Organization, went to Small Claims Court and won a refund of the $112 he figured were his unconstitutional tax payments under the Hurd decision. City Hall is confident of winning a reversal on appeal, but so many of Mr. Pellant's supporters have picked up his cue that the city treasurer has prepared a special rubber stamp, "Paid Under Protest," for their tax returns.

By the state constitution, large cities (except for New York) are limited to a 2% tax on property to pay for operating costs. The rest goes for debt service. In Buffalo, these costs include a $35 million lump sum for the school board, which then sets its own budget. The Hurd decision would squeeze in another $39 million pension costs, which would leave the city absolutely nothing for its operations. Says Mr. Cook, even a 100% personnel layoff wouldn't save enough money to pay Mr. Pellnat's friends' refunds. The whole matter probably will be presented to the state's voters as an amendment to the constitutional tax limit in a referendum this fall.

A SOURCE OF STRENGTH

Buffalo's hard decisions, such as laying off firemen to avoid piling up further deficits, show a political strength lacking in New York City. The source of that strength is fairly obvious. Mayor Makowski and his budget officers have the backing of what has been called the most effective political machine east of Chicago—the Erie County Democratic organization, chaired by Joseph F. Crangle.

Mr. Hurd, who besides suing the city is also the Republican-Conservative candidate for Common Council President, declares, "The Democratic Party's been Crangleized." But even he concedes that Mr. Crangle in 10 years has "done an excellent job of organizing."

"It makes my job a little easier," says Anthony M. Masiello, the 29-year-old majority leader of the Common Council, which is 14 to one Democratic. "And it gives a lot of support to the Mayor."

Mr. Crangle pretty much concentrates on keeping the party in line, leaving financial policy to City Hall. Tightening up the city's management, says Commissioner Burns, "takes a lot of continuity. We've got a very stable political situation in this county and this continuity is of tremendous help in this task."

The brunt of public complaint has fallen hardest on the nine councilmen who represent districts in the city, as compared to the six at-large members of Common Council. "Those guys took an awful lot of flack last year when we were going to increase taxes and decrease services," says Mr. Masiello.

With a sure majority, however, the Buffalo Democrats even have the luxury of allowing nay votes as a safety valve. The black districts, says Mr. Masiello, were especially worried about a 68-man cut in the fire department, because their neighborhoods of old wooden houses have the highest fire rates in the city. The budget passed on June 2 by a 9 to 5 vote, the Democratic opposition coming, as Mr. Masiello expected, from various district councilmen, including the two black members.

But political control, says Budgetmeister Cook, is secondary to following sound policy. "If what we do isn't sound," he says, "no matter how tight-knit the organization is now, it isn't going to stay that way. It's obviously more politically feasible to go into a long-term program of gradual reductions of work force than to make radical changes."

"Sure it's easier to do when we have a tight-knit political organization," he adds, "but it's never easy to do in any political situation."

Mr. Rosenthal. Congressman Drinan?

Mr. Drinan. Thank you, Mr. Chairman.

Chairman Mitchell, I want to be specific and technical for just a moment.

I wonder if 14(b) could be stretched beyond what you suggest here? You indicate that it has not been used since 1933.

How was it used between 1913 and 1933? I take it not for public parties.

It was used, but it has not been used in that period. I just wonder what power there is? What power is latent there? Because that is the only hope that you can give us that something could happen with regard to the Fed.

Mr. Mitchell. I am informed that back in that period, there were purchases to provide assets for Federal Reserve banks and, in some cases, there were purchases to provide liquidity for member banks. Those are the only cases in which that provision was used.

Mr. Drinan. Is there an opposite opinion?

You say that, giving this background the Board does not believe that section 14(b) contemplates the purchase of municipal obligations as a means of aiding financially distressed communities.

Mr. Mitchell. There is no other opinion in the Federal Reserve.

Mr. Drinan. It has never been briefed?

It has never been argued before the Board?

Mr. Mitchell. Not to the best of my knowledge.

Mr. Drinan. In anticipation, I want to welcome Mr. Frank Morris, president of the Federal Reserve Bank of Boston, especially as I am not able to be here due to another committee hearing.

However, I note that in his testimony that he states that the amount of municipal bonds commercial banks can purchase is very likely to decline sharply.

It has gone up over the sixties, from 25 percent to 50 percent, but it looks now as if that will diminish.

That may cause very, very serious new problems.

I wonder whether or not the Federal Reserve has contemplated what could be done?

Mr. Morris testified here 2 years ago before the Ways and Means Committee and we will come to that when he testifies.

However, I wonder if the Federal Reserve has recognized that there is going to be a very serious problem?

Mr. MITCHELL. I think Mr. Morris should comment on that.

I think I know his argument, but he and I have not discussed this recently.

Mr. DRINAN. I appreciate the technical nature of your argument, that is, that you say that this is not within your jurisdiction and you don't want it to be within your jurisdiction.

However, I am sure that you can see the deep concern which is shared by all of us here that financing the cities is going to become more and more difficult and that the vast reserves and the prestige of the Federal Reserve, I hope, could be utilized with prudence in some way.

I thank you for your testimony.

Mr. ROSENTHAL. Congressman Levitas?

Mr. LEVITAS. Thank you, Mr. Chairman.

Mr. Mitchell, is there any legislative history under the Federal Reserve Act that would indicate that one of the purposes of the Central Bank was to provide Federal assistance for distressed municipal and other governments?

Mr. MITCHELL. I don't think so.

Our attorney says there wasn't any.

Mr. LEVITAS. The provisions of paragraph 14(b), that is paragraph 13 of section 13 of the Federal Reserve Act, were primarily designed either for a member bank or for private businesses, is that correct?

Mr. MITCHELL. Yes; I believe so.

Mr. LEVITAS. I know it would sound facetious, Mr. Chairman, that the conditions under which the Central Bank would be authorized to make the loan are such that anybody who can meet those criteria who would need a loan to begin with would certainly be able to get it from any one of the member banks if they could be fully secured under Federal obligations.

Mr. MITCHELL. That is why I think that it is better to describe the Central Banks as a source of liquidity. They might have a good asset, but it might be illiquid.

Mr. LEVITAS. Mayor Beame said and talked about a point which gives me some concern inasmuch as the banks are concerned and the regulations of the banks as it relates to the financial problems which the city of New York finds itself confronted with.

He said that he was concerned that the banks were continuing to buy the short-term paper that the city of New York was selling at a time when the same conditions existed that existed at the time they stopped purchasing the short-term paper.

In effect, he was saying that the banks had not a different picture to look at, they just stopped buying.

Second, he was implying that they were leading the city down the primrose path.

Could you make a comment on that?

Mr. Mitchell. I think the New York City banks have performed their functions there. They buy securities for their own account. They buy securities on account of others. The market for the New York City securities is progressively turning sour, and I suppose any securities that they were buying for others they were unable to sell. How much they are buying for themselves, I don't know, as I don't know the dollar amount of securities that New York City banks hold in New York City bonds and notes in their portfolio.

I assume that, as is true in most cities, the banks of the city in question hold substantial amounts of short-term debt of their local government. They don't own very much long-term debt ordinarily. A long-term debt has an exposure, in a sense, that it can turn out to be very illiquid.

The Commonwealth case is one in which a bank got into trouble in Detroit some time ago. It had a large portfolio of long-term municipal debt. They could not move it without suffering a severe depreciation.

So, banks have a preference as for short-dated debts. In most cities I think that you will find that the banks are very active in short-term financing of the local governments in that area.

I assume the same is true in New York City.

Mr. Levitas. I don't think you responded to my question.

Mr. Mitchell. I don't think I know the answer to it. I am trying to tell you what I did know, not what I did not know.

Mr. Levitas. Mayor Beame, I think, was implying that, if the member banks of the Federal Reserve System were purchasing short-term New York paper for a long period of time and if the circumstances existed at that time, that is, the same circumstances at the time that they ceased purchasing paper, doesn't that pose a regulatory problem to the Board and isn't there also the likelihood, as I implied and the mayor did, that the city was being lead down the primrose path by these banks that pulled the rug out from under it and, when you say that the market turned sour and, therefore, they stopped purchasing paper, then we get into a chicken-and-egg situation.

They stopped purchasing it and that was the souring of the market.

Mr. Gradison. Would the gentleman yield?

Mr. Levitas. Yes.

Mr. Gradison. To me, what we are talking about was well described in the story of the Emperor's new clothes.

I don't think the only explanation for this is a conspiracy.

Mr. Levitas. I certainly don't mean to imply that. After I get an answer to my question, I was going to indicate my general agreement with Mr. Mitchell's statement.

Mr. Mitchell. I have a little information from my staff. There is about $6 billion of this short-term debt and the banks hold about $1 billion. So, the other has to be sold to someone else.

Mr. Rosenthal. The point my colleague was making was that the banks have been part and parcel of this modus operandi for a long period of time and that it ill behoved them to pull the rug out of a "scheme" and that they were profiting partners for a long period of time.

Mr. Mitchell. I think you are looking at the banks as the "bad guy" whereas it may be that some investor such as an insurance company which is buying these securities just decided that all these securities are not very good anymore and that they are not going to buy them anymore.

When that happens and how it happens——

Mr. ROSENTHAL. When they get the cream of the milk, they don't want it anymore.

Mr. MITCHELL. You may be right, but that is the way investors are.

Mr. ROSENTHAL. How was the city of New York's debt rated by the Federal Reserve examiners?

Mr. MITCHELL. It was in investment grade. It is eligible for investment.

Mr. LEVITAS. Before I get back to my major line of questions, this is a rather naive one, but I would like to understand it. It relates to long-term debt rather than to short-term debt.

What happens if a local government defaults on its bonds?

Does the bondholder actually come over and take over the property of the city, or what?

Mr. MITCHELL. All the bondholders form a committee and try to get things back on the track so that they can get their money back.

Mr. LEVITAS. They don't foreclose on the waterworks?

Mr. MITCHELL. No; I don't recall any of that. They just have to negotiate.

Mr. LEVITAS. That relates somewhat to the question that the chairman asked earlier.

What would be the consequences?

Mr. MITCHELL. As I was saying to Mr. Gradison, I think the consequences for New York with that large volume of debt would be very serious because investors would say that the city defaulted.

I would not have that. That black mark persists for a generation.

Mr. LEVITAS. How do the noteholders, the banks, and other purchasers, get their money back?

They sue the city. They get a judgment against the city.

Now what?

Mr. MITCHELL. I am not familiar enough with cases of this sort to say what the routine is, but I think what has happened generally is that the issue has been refinanced, reforms have been put into effect and, gradually, they have worked their way out.

However, that takes a long time.

Mr. LEVITAS. Let me say, Mr. Mitchell, that I, for one, as an individual agree with the position that you have taken in your statement that it would not be appropriate even if the law were changed to put the Federal Reserve bank in the business of providing assistance to municipalities or other governments.

Whether or not another Federal agency should do so, I am not prepared to say at this time, but I think it would be a disastrous course for the Congress to put the Central Bank in that business.

By the same token, I would also be against having anyone trying to say that the Central Bank is in some way responsible for the problems of the city of New York and did not do something that they should have done to bail out New York City. I think that is also in my humblest opinion looking for the wrong statement.

I would like to ask you to expand briefly on one or two statements that you made.

On page 2 of your testimony, the last part of the last sentence in the first paragraph referring to the city says, "its basic need for credit did not appear to be of a temporary character inasmuch as no near-term means of repayment—while continuing to provide the city's basic services."

First of all, could you comment on that and then, take it further into the future as to what it means in a long range solution to the problem of financing the city of New York and other cities?

Mr. MITCHELL. I am not really qualified to offer a view as to how New York can get out of its financial difficulties.

As I said earlier, I think that the division of tax resources between the State and the local government is the most important single factor and that if the city is attempting to exercise certain functions without financial resources to do it, it is going to encounter a financial disaster of some kind.

So, I believe that there is an imbalance here between resources and functions. That is the basic problem, as I see it, that New York faces, or is at least one of the basic problems.

There are other problems that it faces, for example, high operating costs, arising from the fact that it is a very concentrated community, a congested community.

However, New York is also a very rich area and it is very rich in its human resources as well as in its material resources.

Mr. LEVITAS. But, in terms of its future credit worthiness does not your statement on page 2 imply that the solutions that need to be sought are not merely financing mechanics which come out of the Federal Government or even financing mechanisms that come out of State governments, but that it involves a redefinition of functions and a reassessment of services and revenues and, in the absence of that, no short-term mechanism or Federal corporation or State assistance is going to solve this?

Mr. MITCHELL. That is right. It can bridge you into that, perhaps, but no more than that.

Mr. LEVITAS. On page 5 of your testimony, in the middle of the page, you discuss Federal and State and you point out your objections against proposals that would permit distressed cities to have access to the Central Bank.

We have heard testimony from several people and comments from members of this subcommittee that tend to equate the credit worthiness and fiscal policies of businesses and banks' relationships with businesses with the fiscal policies and operations of Government and the banks' relationships to Government.

It seems to me—and I relate this to your comments on page 5—that you cannot apply the same rules to a Government as you can to a business when it comes to extend credit.

On the income side, in the case of a Government you are dealing with political decisions. This is translated in the form of taxes and other levies which require political judgments and political guts.

In the case of business your revenue or income is determined by sales or whatever income generating ability you have.

In case of expenses for Government, again it is a political matter. It is what the politicians will provide as funds in response to public demand.

In the case of business, presumably, it is that amount of expenditure which is necessary in order to produce the anticipated profits.

You don't have a potential for profit in the case of the Government that you do in a business that you evaluate.

It seems to me that you have to evaluate the determination of the elected officials to propose the necessary taxes, and to cut out the services in order to provide the revenues to repay.

Mr. MITCHELL. I think you are right. We discussed it quite a little bit earlier. There is a difference. The rules of the game have been drafted around business enterprises and financial enterprises of one kind or another. For example, governments are different in respect to their assets. These assets cannot be seized.

The area of similarity probably is the flow of assured revenues which exist in the case of governments. This has given rise to the tax anticipation financing which has occurred.

Mr. LEVITAS. Thank you.

Mr. ROSENTHAL. Thank you very, very much, Mr. Chairman.

We find your testimony very enlightening.

Mr. MITCHELL. Thank you. I enjoyed it very much.

Mr. ROSENTHAL. Our next witness is Mr. Frank E. Morris, president of the Federal Reserve Bank of Boston.

Mr. Morris, we will be glad to hear from you at this time.

STATEMENT OF FRANK E. MORRIS, PRESIDENT, FEDERAL RESERVE BANK OF BOSTON

Mr. MORRIS. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I am happy to be here.

Mr. ROSENTHAL. There is something I don't know.

Is the president of the Federal Reserve Bank of Boston an official governmental position?

Mr. MORRIS. The Federal Reserve banks are instrumentalities of the U.S. Government. We are not part of the executive branch of the Government. We are responsible to the Congress.

Mr. ROSENTHAL. In other words, you are not a full-time Government employee?

Mr. MORRIS. Yes.

Mr. ROSENTHAL. You are?

Mr. MORRIS. Yes, I am.

Mr. LEVITAS. Do you have a Chairman of the Board also?

Mr. MORRIS. We have a Board of Directors chosen from people in New England.

I am appointed by the Board of Directors, but my appointment has to be confirmed by the Board of Governors in Washington.

Mr. LEVITAS. The Chairman of the Board is a citizen who is not a full-time employee?

Mr. MORRIS. Yes, that is correct.

My Chairman is Louis Cabot, who is chairman of the Cabot Corp., and who works in a part-time capacity along with my other directors.

Mr. Chairman, I would propose to confine my testimony to the condition of the municipal bond market and to two actions which Congress should take to strengthen that market.

I am speaking for myself—not for the Federal Reserve System. I have been a student of the municipal bond market for a number of years.

It seems to me that there are certain steps which the current state of the market calls for, certain steps which can be taken through congressional action.

The municipal bond market is in disarray, with interest rate spreads between tax-exempt and taxable bonds at the lowest levels in our history. The market is subjected to great strains caused by one temporary source and two fundamental, longer term sources of weakness.

The temporary source of strain, of course, is the shock to investor confidence in municipal bonds stemming from the financial difficulties of New York City which, in turn, has affected the ability of many other cities to obtain financing on reasonable terms.

My own city of Boston, which is in sound financial condition, was required recently to scale back an offering of securities because of the general demoralization of the market.

However, even when the confidence of the investor in the financial integrity of our cities is restored, the municipal bond market will still face two longer-term problems: inflationary expectations among investors, which have weakened all of our capital markets; and the fact that the municipal bond market is much too narrowly based to provide an efficient financing vehicle for State and local governments in the years ahead.

We have found that our cities are very vulnerable to inflation. Both their operating costs and their borrowing costs are extremely responsive to inflation, while their revenues are much less responsive. The problem is particularly acute in cities which depend heavily on the property tax for their revenues. The high rates of inflation of recent years have contributed to a financial squeeze from which few of our cities have been immune.

If, in the economic expansion that lies immediately ahead of us, we fail to deal adequately with the longer-term problem of inflation, the financial problems of our cities in 1979 and 1980 are likely to be even more severe than they are today.

Our capital markets generally will not be restored to full health until the investor is convinced that inflation has been brought under control and will be kept under control in the future. As long as the investor fears a high rate of inflation in the future, he will respond by investing in short-term maturities, leaving the intermediate and long-term bond markets very thin and unable to cope with the demands placed upon them.

Even if inflation is dealt with effectively in the years ahead and health restored to our capital markets generally, the municipal bond market will still be left with serious structural problems that must be resolved if we are to have an efficient market for the securities of State and local governments.

The present tax-exempt market, which is supported primarily by commercial banks, casualty insurance companies, and wealthy individuals, served State and local governments well in the decade of the sixties only because commercial banks were in a position to absorb 70 percent of all new offerings. It is because the commercial banking system will not be able to provide this kind of support in the future, that the market must be broadened.

At the beginning of the decade of the sixties, commercial banks held 25 percent of all municipal bonds outstanding; by the end of that decade they held 50 percent of the total. Commercial banks found room in their portfolios for this great increase in municipal bonds only by reducing their holdings of U.S. Government securities sharply—from 31 percent of their total assets in 1960 to a little over 13 percent by the end of 1970. With Treasury security holdings now at minimal levels, this is a performance which cannot be repeated in the future.

There are other reasons why commercial banks will have relatively less interest in municipal bonds in the years ahead. Bank holding companies are finding other, more profitable offsets to taxable income, particularly in their leasing subsidiaries, through the investment credits and heavy depreciation write-offs which they generate.

The largest banks which have mature foreign branches are generating substantial tax credits which also reduce the need for tax-exempt income.

In addition to these long-term factors, banks will suffer heavy loan losses in 1975, a fact which makes taxable securities relatively more attractive.

The current weakness in the municipal bond market is not surprising; it has been foreseen for a number of years. In my testimony before the House Ways and Means Committee in February 1973, I stated:

> I believe there was a one shot quality in the level of support of the municipal bond market by commercial banks in the sixties. In my judgment, the commercial banks will not be in a position to support this market on a similar scale in the seventies and without heavy support by the commercial banks, the tax-exempt municipal bond market is not likely to be able to carry adequately the financing load which will be imposed upon it in the years ahead. Quite apart from considerations of tax equity, there is a need to be planning now for the establishment of an alternative taxable market for municipal bonds.

My forecast was realized somewhat more rapidly than I had expected: for the weakness demonstrated in the first half of 1975 was completely unprecedented.

Normally the municipal bond market functions very well during recessions. The banks find business loan demand declining and typically in recessions have invested a large part of their free funds in municipals.

In a normal recession of the past, banks have bought all of the newly issued municipal bonds and the market functioned well.

This did not happen in 1975. In the first quarter, commercial banks took less than 1 percent of the newly issued bonds. Casualty insurance companies, having profitability problems, bought less than 6 percent. Wealthy individuals constituted almost the entire market, taking down about 96 percent of the total.

Whenever this happens, interest rates must rise high enough to attract the marginal individual, and investors in high tax brackets receive a windfall.

In my testimony before the Ways and Means Committee in 1973, I advocated a bill which would provide a 40 percent Federal interest subsidy on all State and local government securities sold on a taxable basis.

The evidence is, I think, even more compelling today that State and local governments need the authority to issue bonds both on a taxable and a tax-exempt basis, permitting them to retain the traditional markets for their securities and, in addition, to tap the great bond-buying potential of the pension funds, both private and public, which are now foreclosed to them.

Such a dual market would offer lower net interest costs to State and local governments. Having the option to sell taxable bonds with a 40 percent interest subsidy would mean that tax-exempt bonds would never be sold at an interest rate higher than 60 percent of the equivalent taxable rate. As a consequence, the element of inequity in our income tax system introduced by tax-exempt bonds would be substantially reduced.

My second proposal for congressional action is to repeal the present provision of the Internal Revenue Code providing tax exemption to industrial pollution control bonds, replacing this privilege with a special investment credit for antipollution related investments.

I believe this country needs to stimulate investment and I think it entirely appropriate that we aid corporations which are required to make substantial additional investments in the interest of cleaning up our air and water. However, I believe that tax exemption on industrial pollution control bonds is a very poor device to achieve these ends.

The industrial pollution control bonds have overloaded our tax-exempt bond market, increasing the cost of financing for all traditional State and local government investment purposes.

Furthermore, they have the effect of narrowing the spreads between tax-exempt and taxable bonds and, thereby increasing the inequities in our income tax system.

The inefficiency of the present subsidy to corporations on industrial pollution control bonds is enormous. I think it is almost a national disgrace.

John Petersen, the able economist for the Municipal Finance Officers Association, has estimated that by 1980, $25 billion in industrial pollution control bonds will be outstanding. The interest savings to corporations over this period he estimates at $425 million, while the cost of this subsidy to Federal, State and local governments would amount to an estimated $790 million—the remaining $365 million of benefits accruing to the holders of the tax-exempt bonds.

Of the $790 million total estimated costs of this subsidy through 1980, $600 million would be borne by the Federal Government in lower income tax receipts, $150 million would be borne by State and local governments in the form of an increase in their borrowing costs due to the overloading of the tax-exempt market and $40 million would be lost to State and local governments in reduced income tax receipts.

Inasmuch as the corporations will actually receive less than 54 percent of the benefits of this subsidy, it would obviously be better to provide the subsidy directly through a special investment credit on pollution control investment.

With the prospective overloading of the tax-exempt market by industrial pollution control bonds eliminated and with State and local governments in a position to tap both their traditional markets and the new markets which the optional taxable bond would open to them, issuers of municipal bonds would have a sound market structure for their securities.

In the absence of these two reforms, I would expect continued difficulties for an overloaded tax-exempt bond market in the future.

Thank you, Mr. Chairman.

Mr. ROSENTHAL. Is there any agency of Government that you see bearing any degree of responsibility for this situation which you described?

Mr. MORRIS. I think that these issues have been before the Congress for a great many years now. The proposal for a dual market in municipal bonds was taken up initally by the Ways and Means Committee in 1969.

I testified before the Senate Banking Committee and before the Ways and Means Committee on this.

I think it is important not only to improve the market for State and local securities, but I believe it is also important to reduce the inequity in our income tax system which tax exemption on these bonds provides.

Mr. ROSENTHAL. Going back to the first part of your statement, I kind of sense that if New York City defaulted, it would have a stunning depressing effect on the bond market.

Essentially, that is your opinion, isn't it?

Mr. MORRIS. The effect of New York City's financial problems is already in the market. I doubt that an actual default would cause more problems.

Mr. ROSENTHAL. So, the market is already anticipating the default?

Mr. MORRIS. No; it has not anticipated default, but I think the confidence in the bonds of our large cities has been shaken, and I believe that we will have a cloud over the market until the problem of New York City is resolved.

Mr. ROSENTHAL. Do you think that the Federal Reserve has any responsibility or role that can be useful in any way beyond what Mr. Mitchell testified?

Mr. MORRIS. No; I fully share the views of Mr. Mitchell.

If the Congress feels that it is in the public interest to establish an organization to provide emergency assistance to cities, then that is all well and good.

There are a lot of problems which any such agency would run into.

However, I think this power should not be given to the Federal Reserve System.

Mr. GRADISON. I want to thank Mr. Morris for his testimony which I found quite helpful.

I want to ask him a question in relation to page 6. In the middle of that page, you indicate with regard to the great bond buying potential of pension funds, both public and private, that they are now foreclosed.

I understand what you are talking about in financial terms, but aren't they foreclosed not so much by the fact that they are tax exempt but by the fact of the rates which results from the tax-exemption feature?

Isn't it possible that, in order to market tax-exempt bonds, we will gradually reach a point where they are priced to provide yields which will be attractive to tax-free institutions? Thereby, the tax-exemption feature becomes irrelevant, but a new market would be opened up?

Mr. MORRIS. What you are saying is that the tax exemption would be worthless because of the deterioration of the market.

Mr. GRADISON. That is right.

Mr. MORRIS. In that case, the Federal Government would be providing a large subsidy to State and local governments through the tax exemption, and the State and local governments would be getting zero for it.

Mr. GRADISON. I am not arguing the equity issue. I understand what you are saying very clearly.

There would be a complete windfall advantage to those taxable investors who happened to purchase portions of those issues which were priced at a marginal level to attract funds from the tax-exempt funds; that is what you are saying, and I understand that.

However, in terms of the ability of State and local governments to finance, isn't it possible that what we are moving toward is a new pricing system for such securities where they are going to gradually have to compete on the basis of not only the interest rates but creditworthiness with the corporations and other major borrowers in order to be able to attract investment from those very large new pools of savings, particularly in the tax-exempt field of pension funds and profit-sharing funds, and so forth?

I am just saying that isn't it possible that there may be some mechanism that works in the market that will permit State and local governments to get their financing albeit at very high interest rates and albeit with a windfall for individual investors?

Mr. MORRIS. That process is at work right now.

In order to clear the market with the current volume of financing and with the uncertainties in the market, the tax-exempt yields have been pushed up to about 80 percent of the taxable equivalent rate. Of course, this produces great inequities in our income tax system, great windfalls to the high bracket investor, but the market does clear the securities.

If you get up to 100 percent of the taxable equivalent yields then obviously, the tax exemption has no value at all. Then, you could have bonds sold to pension funds, but I think it would clearly be better to give State and local governments the authority to issue taxable bonds, and to sell those taxable bonds to the pension funds rather than to drive down the value of the tax exemption close to zero.

Mr. GRADISON. I would concur with your conclusion. I just did not want to leave the impression that the present situation in itself foreclosed the ability of State and local governments to finance themselves.

The only other point I raised—and this is just a general comment—is that I don't think we really know with any certainty what the taxable equivalent is; that is to say, I don't think we are going to know until taxable State and local bonds are issued, whether the preference of large investors will be for a Cincinnati, Ohio, bond with a 30-year maturity yielding 9 percent, or American Telephone bonds of 9 percent with the same maturity?

We really don't know how it is going to be.

Mr. MORRIS. From my experience in the investment market, I would judge that most investors would be willing to pay a premium for the A.T. & T. bond because it would have a better secondary market.

But apart from a better secondary market, which high grade corporate bonds have, I would expect that there would be relatively little difference.

Mr. GRADISON. Thank you very much.

Mr. ROSENTHAL. Congressman Evans?

Mr. EVANS. Evidently, you feel that Congress can take an active role in this area.

I wonder what steps you feel the cities could take to aid their soundness in municipal bonds in the market?

Mr. MORRIS. I think that the great bulk of our cities are soundly managed. The city I know most about is my home city of Boston.

The city was running into financial problems about 2 years ago. We have a strong and vigorous mayor who recognized the problems. The financial people of Boston pointed these problems out—that, if nothing was done, the city of Boston was going to run into problems.

So, something was done. The city of Boston cut its payroll 10 percent which was an extremely difficult thing for Mayor White to pull off, but he did it.

If he had not done it, the position of the city of Boston now would be extremely precarious.

So, I think we have got to have responsible management of our State and local governments.

There is really no substitute for that.

Mr. EVANS. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Thank you very much, Mr. Morris. We appreciated your testimony very much.

Our next witness is Prof. Edwin T. Haefele of the University of Pennsylvania.

Professor Haefele, we are pleased to have you with us today.

STATEMENT BY EDWIN T. HAEFELE, PROFESSOR OF POLITICAL SCIENCE, UNIVERSITY OF PENNSYLVANIA

Mr. HAEFELE. Thank you, Mr. Chairman.

I believe you have my written statement. Is that not correct?

Mr. ROSENTHAL. Your statement in toto will be included in the record.

Mr. HAEFELE. The only thing that I like to emphasize this morning is that I will be backing up a little bit from the strictly financial subjects that we have been talking about earlier to get to what I think is the root cause of municipal corporate problems in this country—the fact that the corporate reach of the city does not coincide with its economic reach.

In other words, it is possible for suburbs to separately incorporate themselves. By such incorporation, they protect themselves from city taxes.

That seems to me to be the root cause behind most of the troubles of central cities.

Mr. ROSENTHAL. How does the superior court's decision affect that?

I did not read it carefully. I just saw the headline.

Mr. HAEFELE. I don't know.

Mr. ROSENTHAL. Inasmuch as neither of us know much about it, go ahead.

Mr. HAEFELE. It seems to me that the problems of the city cannot be solved until we focus on this question of the reach of the city's taxing power. It is not a new problem.

The city of London was complaining hundreds of years ago about city merchants who were setting up stalls outside the city boundaries, protected from city taxes while enjoying city markets.

The same thing happens today on a very vast scale.

In my written testimony, what I have suggested is that States should be urged to rewrite their municipal corporate law so that municipalities could tax residents outside their own boundaries insofar as those residents derive their livelihood from the city itself.

This is done in a few instances today in various payroll taxes, but I regard that as a meat ax approach to what is a more complicated problem.

This cannot be done by Federal action. It has to be done by revising the State laws.

What the Federal Government can do is to revise the revenue-sharing formula so that it takes account of where people work in the daytime as well as where they sleep at night.

I recognize that the revenue-sharing formula is extremely difficult to pry apart and put back together and, if it were pried apart, I don't know whether it could be put back together.

However, I suggest it needs to be pried apart for this reform.

Furthermore, I believe that welfare rights should be vested in individuals just as the GI bill vests rights in individuals so that the total welfare burden, which is a national burden, when there are no laws against internal migration, be faced as a national problem.

I further suggest that the negative income tax is a way of achieving that welfare vesting.

Third, at the Federal level, it seems to me that the Federal grants-in-aid programs have outlived their usefulness.

They were originally an incentive to get States and localities to initiate programs that were felt to be in the national interest and to help pay for those programs.

What they now do is simply to provide a perverse incentive system. Federal money is there, it is there for particular purposes and it biases local choices.

I would urge that Federal grants-in-aid, as a general principle, would be replaced with programs that are in the national interest, totally funded by the National Government and, therefore, controlled by the National Government. Programs which are State and local should be funded by State and local governments with revenue-sharing money.

At the local level—and this is my last point—it seems to me that the only thing the Federal Government should take cognizance of is that private investors have taken off most of the cream. They have insulated from general purpose governments most of the profitable enterprises and profitable opportunities that local governments have.

The Port Authority in New York is a case in point. This Authority was set up as a fiscal marvel, but it is absolutely a disaster in terms of local self-government. It takes a profitable part of the public fisc, insulates it from general purpose government, and——

Mr. ROSENTHAL. Can you give us an example of what you mean there?

Mr. HAEFELE. A toll which is dedicated to a particular bond retirement is an example.

Any moneys that are earmarked for the retirement of specific obligations of the authority; specific revenues controlled by an authority; water bonds; all of the things, in other words that the gentlemen who preceded me are delighted about in local authority finance. They are things that seem to me to be things that should be changed.

Mr. ROSENTHAL. What specific recommendations do you make for the Federal Government including the bank regulatory agencies and the Congress itself?

Mr. HAEFELE. The Congress should face this problem by trying to channel some of its revenue-sharing money directly to places where people work rather than all of it to where they live. That is something that the Federal Government could do.

The Federal Government could look again at this welfare question and face, for the first time, the fact that it is simply a national redistribution of income and should not be a burden on the citizens of New York City.

Mr. ROSENTHAL. What views or thoughts do you have?

Mr. HAEFELE. The only thing that I would point out is that I think New York City has done exceptionally well in spite of the fact that it has much of its potential revenues drained off by agencies such as the port authority.

I would hope that we would see in the future fewer of these special authorities and more local revenues dedicated to the general purpose governments rather than to the special-purpose governments.

Mr. ROSENTHAL. How do we reverse the trend of the port agencies? What do we do now?

Mr. HAEFELE. What do we do now?

The Federal Government cannot do much directly about these kinds of governments. They were put in place back in an earlier period of fiscal mismanagement of cities. The financial experts and bond sellers designed these special-purpose authorities in order to finance needed expansion.

Those expansions have, by and large, taken place and what you have now is a situation where the Port of New York Authority does things like build the Trade Center buildings in spite of very substantial local opposition to those buildings.

However, there was no way that that opposition could control the authority. It is totally out of local hands.

What the Federal Government could do about that is to withdraw Federal tax exemption from the obligations of such special authorities.

Mr. ROSENTHAL. Thank you very much, Professor, for your recommendations.

We seem to always wind up in a dilemma. I don't know how we are going to get out of it, but I think we have the motivation to do it.

Thank you very much.

At this point, I would like to enter into the record the selected bank soundness data and a letter from Mr. Haefele.

[The data and letter follow:]

SELECTED BANK SOUNDNESS DATA

TABLE 2.—DOMESTIC CAPITAL, ASSETS AND LOAN LOSSES, LARGEST 50 BANKS

[In millions of dollars]

Bank name	Report of conditions, Dec. 31, 1973				Report of conditions, Dec. 31, 1971				Report of conditions, Dec. 31, 1969			
	Total [1] assets	Capital [2] to assets	Net loan [3] losses to assets	Net loan losses to capital	Total [1] assets	Capital [2] to assets	Net loan losses to assets	Net loan [3] losses to capital	Total [1] assets	Capital [2] to assets	Net loan [3] losses to assets	Net loan losses to capital
Bank of America	32, 270	0. 060	0. 0020	0. 0333	24, 952	0. 061	0. 0017	0. 0279	20, 157	0. 069	0. 0011	0. 0159
First National City Bank	24, 195	. 095	. 0029	. 0305	17, 640	. 096	. 0024	. 0250	16, 888	. 101	. 0007	. 0069
Chase Manhattan Bank	23, 106	. 084	. 0032	. 0381	18, 481	. 097	. 0024	. 0247	19, 503	. 076	. 0005	. 0066
Chemical Bank	14, 207	. 057	. 0013	. 0228	10, 648	. 070	. 0021	. 0300	9, 235	. 077	. 0002	. 0026
Manufacturers Hanover Trust	13, 498	. 069	. 0010	. 0145	11, 776	. 072	. 0013	. 0181	10, 658	. 074	. 0004	. 0054
Morgan Guaranty Trust Co	13, 150	. 091	. 0002	. 0022	10, 334	. 089	. 0003	. 0034	9, 470	. 087	. 0002	. 0023
Continental Illinois National Bank	12, 197	. 073	—. 0001	—. 0014	7, 226	. 096	. 0019	. 0198	6, 199	. 101	. 0015	. 0149
Bankers Trust Co	11, 769	. 061	. 0025	. 0410	7, 480	. 070	. 0041	. 0586	7, 774	. 064	. 0005	. 0078
First National Bank of Chicago	11, 215	. 073	. 0015	. 0205	6, 956	. 099	. 0035	. 0354	5, 985	. 111	. 0005	. 0045
Security Pacific National Bank	11, 068	. 062	. 0019	. 0306	8, 535	. 070	. 0036	. 0514	6, 706	. 081	. 0006	. 0074
Wells Fargo Bank	9, 416	. 057	. 0012	. 0211	6, 789	. 061	. 0010	. 0164	5, 459	. 073	. 0013	. 0178
Crocker National Bank	8, 187	. 044	. 0007	. 0159	5, 614	. 059	. 0021	. 0356	4, 893	. 061	. 0018	. 0295
United California Bank	7, 188	. 057	. 0015	. 0263	5, 650	. 055	. 0021	. 0382	4, 615	. 065	. 0011	. 0169
Mellon Bank	6, 412	. 092	. 0003	. 0033	4, 544	. 119	. 0018	. 0151	4, 244	. 121	. 0002	. 0017
Irving Trust Co	6, 005	. 061	. 0010	. 0164	4, 120	. 075	. 0044	. 0587	5, 224	. 059	. 0002	. 0034
National Bank of Detroit	5, 802	. 086	. 0003	. 0035	5, 124	. 072	. 0006	. 0083	4, 352	. 074	. 0005	. 0068
First National Bank of Boston	4, 879	. 094	. 0055	. 0585	3, 817	. 108	. 0024	. 0222	3, 585	. 106	. 0008	. 0075
First Pennsylvania Banking & Trust Co	4, 641	. 061	. 0017	. 0279	3, 202	. 065	. 0016	. 0246	2, 314	. 082	. 0009	. 0110
Union Bank	4, 359	. 046	. 0023	. 0500	3, 224	. 045	. 0034	. 0756	1, 994	. 064	. 0010	. 0156
Franklin National Bank	3, 805	. 051	. 0042	. 0824	3, 262	. 059	. 0043	. 0729	2, 804	. 063	. 0000	. 0000
Seattle First National Bank	3, 611	. 064	. 0011	. 0172	2, 602	. 074	. 0012	. 0162	2, 048	. 083	. 0010	. 0120
Cleveland Trust Co	3, 397	. 104	. 0011	. 0106	2, 677	. 114	. 0030	. 0263	2, 520	. 109	. 0004	. 0037
Philadelphia National Bank	3, 376	. 066	. 0015	. 0227	2, 283	. 087	. 0013	. 0149	2, 182	. 078	. 0005	. 0064
Marine Midland Bank, New York	3, 363	. 066	. 0012	. 0182	3, 147	. 063	. 0041	. 0651	2, 379	. 077	. 0008	. 0104
Harris Trust & Savings Bank	3, 088	. 080	. 0006	. 0075	2, 193	. 089	. 0005	. 0562	1, 904	. 090	. 0005	. 0056
Republic National Bank of Dallas	3, 068	. 065	. 0010	. 0514	2, 476	. 066	. 0032	. 0485	2, 110	. 075	. 0005	. 0067
Valley National Bank of Arizona	2, 936	. 051	. 0007	. 0137	2, 422	. 053	. 0017	. 0321	1, 622	. 060	. 0012	. 0200
Wachovia Bank & Trust	2, 934	. 065	. 0003	. 0046	2, 013	. 081	. 0010	. 0123	1, 667	. 084	. 0000	. 0000
North Carolina National Bank	2, 913	. 052	. 0010	. 0192	1, 850	. 061	. 0011	. 0180	1, 330	. 069	. 0008	. 0116
Detroit Bank & Trust Co	2, 845	. 073	. 0007	. 0096	2, 358	. 077	. 0004	. 0052	2, 100	. 076	. 0005	. 0066
Citizens & Southern National Bank	2, 737	. 080	. 0051	. 0638	1, 688	. 096	. 0036	. 0375	1, 472	. 079	. 0020	. 0253
First City National Bank of Houston	2, 705	. 051	. 0004	. 0078	1, 776	. 060	. 0011	. 0183	1, 213	. 082	. 0008	. 0098
Manufacturers National Bank	2, 698	. 059	. 0007	. 0119	2, 353	. 056	. 0004	. 0071	1, 969	. 058	. 0000	. 0000

See footnotes at end of table.

SELECTED BANK SOUNDNESS DATA

TABLE 2.—DOMESTIC CAPITAL, ASSETS AND LOAN LOSSES, LARGEST 50 BANKS—Continued

[In millions of dollars]

Bank name	Report of conditions, Dec. 31, 1973				Report of conditions, Dec. 31, 1971				Report of conditions, Dec. 31, 1969			
	Total [1] assets	Capital [2] to assets	Net loan [3] losses to assets	Net loan losses to capital	Total [1] assets	Capital [2] to assets	Net loan [3] losses to assets	Net loan losses to capital	Total [1] assets	Capital [2] to assets	Net loan [3] losses to assets	Net loan losses to capital
First National Bank in Dallas	2,697	.072	.0011	.0153	2,260	.073	.0004	.0055	1,797	.079	.0006	.0076
Girard Trust Bank	2,655	.073	.0015	.0205	2,141	.084	.0023	.0274	1,770	.093	.0011	.0118
Bank of California	2,652	.043	.0030	.0698	2,233	.046	.0018	.0391	1,828	.052	.0011	.0212
First National Bank of Oregon	2,646	.062	.0008	.0129	2,154	.068	.0009	.0132	1,917	.068	.0010	.0147
National Bank of North America	2,607	.086	.0031	.0360	2,300	.086	.0026	.0302	1,710	.075	.0018	.0240
Northern Trust Co	2,577	.076	.0004	.0053	1,949	.090	.0005	.0056	1,508	.100	.0007	.0070
United States National Bank	2,547	.059	.0012	.0203	1,971	.066	.0020	.0303	1,681	.072	.0012	.0167
Pittsburgh National Bank	2,518	.079	.0020	.0253	2,033	.092			1,841	.090	−.0005	−.0056
National City Bank	2,132	.087	.0005	.0057	1,720	.098	.0017	.0173	1,596	.092	.0006	.0065
Marine Midland Bank, Western	2,098	.081	.0024	.0296	1,897	.084	.0032	.0381	1,504	.099	.0007	.0071
Fidelity Bank	1,969	.076	.0010	.0132	1,632	.070	.0025	.0357	1,433	.072	.0007	.0097
First National Bank of Arizona	1,921	.047	.0005	.0106	1,322	.058	.0015	.0259	904	.059	.0011	.0186
First Union National Bank of Charlotte	1,900	.062	.0005	.0081	1,311	.067	.0008	.0119	1,005	.066	.0010	.0152
National Bank of Commerce of Seattle	1,895	.064	.0016	.0250	1,436	.074	.0014	.0189	1,177	.079	.0008	.0101
Indiana National Bank	1,833	.059	.0016	.0271	1,520	.064	.0026	.0406	1,216	.073	.0016	.0219
Texas Commerce Bank National Association	1,882	.068			1,417	.073			1,074	.094	.0000	.0000
First Wisconsin National Bank	1,855	.057	.0035	.0333	1,530	.031	.0020	.0313	1,265	.075	.0008	.0107

[1] Total assets are for the domestic consolidated bank from the report of condition as of December of each year.

[2] Capital is equity capital plus reserves for loan and security losses from the report of condition as of December of each year.

[3] Net loan losses are actual loan and security losses less actual recoveries for each year from the report of income and dividends.

NEWPORT, R.I., *June 26, 1975.*

Representative BENJAMIN S. ROSENTHAL,
Rayburn House Office Building,
Washington, D.C.

DEAR REPRESENTATIVE ROSENTHAL: Let me make a delayed response to a question you asked me yesterday, i.e., what can we do about the number of special purpose governments we now have at the local level that are skimming the cream of revenues from general purpose local governments.

The answer is; that you change the tax law on exemptions of local securities, making only the securities issued by general purpose local governments exempt from Federal income tax, while securities issued by special purpose governments, e.g., the Port authority, become subject to Federal income taxes.

Such a change would give the securities issued by real local governments (like New York City) a competitive advantage over special governments securities on the one hand and would cool the ardor of the financial community toward the creation of special purpose governments in the future.

With best wishes,

EDWIN T. HAEFELE.

Mr. ROSENTHAL. The subcommittee stands adjourned.

[Professor Haefele's prepared statement follows:]

PREPARED STATEMENT OF EDWIN T. HAEFELE, PROFESSOR OF POLITICAL SCIENCE, UNIVERSITY OF PENNSYLVANIA

The plight of the municipal corporation in America can be introduced by reference to the family with modern children. The children come and go as they please, but the dirty laundry, the school bills and all other financial items are thought to be fit subjects for only the parents to deal with.

So it is with the American city, expected to cope with whatever problems its thoughtless children—the suburbs—prefer to keep out of their own bailiwick.

The comparison does not take us very far into the mysteries of modern municipal finance, but it does point up a central and often overwhelming fact—the corporate reach of a modern city does not coincide with its economic reach. No new thing, that, since the City of London was complaining hundreds of years ago to the King about merchants setting up stalls outside the City walls, escaping City taxes while enjoying City markets.

So long as the satellite communities and businesses were small in comparison to the city, such chiseling (or entrepreneurship if you prefer) was not serious. But many parasites are dumb enough to kill their hosts, and in this country many suburban areas have drained their host cities, legally, through the simple device of separate incorporation and the pursuit of self-interest in tax and zoning policies.

If a thing can be done, and it is profitable to do it, then it will be done. What was done to central cities a generation or more ago is now happening to the inner suburbs as they face a declining tax base, old housing stocks, and competition from newer municipal corporations still farther out.

The issue is not, therefore, the central city vs. the suburbs, but the municipal corporation as a legal entity and the reach of its taxing power. Let me try to make the point more strongly. Grant one local government *full* taxing power over the economic reach of a city (the laborshed would be an approximate and flexible boundary; the SMSA definition a less precise one) and no American city, with the possible exception of New York City, would have any financial problems. State governments might have difficulty making ends meet; and the Federal Government might be 50 percent smaller (would that such a blessing might occur) but the cities would be fine.

We cannot, of course, return to the free cities of the Middle Ages, but the point must be grasped. Cities, as economic entities, are the source of most of our productive wealth. Cities are in financial trouble because and only because they are being bled too much by too many.

The Federal Government is itself a prime candidate for some of the blame. If the Congress had not passed laws that take more income from city residents than they can afford; if the Congress had passed laws that vest welfare rights and payments in the individual regardless of where he lives (as the G.I. Bill does); then many American cities would be in much better financial shape than they are now.

Since most Americans were better off, however, by allowing the burden of welfare payments to fall on a few, the Congress accurately reflected that mood for the last 20 years or so. Now we are beginning to realize that a short run gain has become a long run loss for us all.

The Federal Government is by no means the only culprit or expert on bleeding cities. There has grown up in recent years a particularly rapacious and self-righteous bunch of bandits operating out of organized city gangs that are whimsically called municipal "unions". (The peculiarities of city argot are endlessly fascinating.) These unions are exploiting the same monopoly power that the suburban governments and the OPEC nations have discovered. The pension settlements recently won in some cities, for example, can only be realized by one of two means—either the number of municipal employees is drastically reduced or the Federal Government must take over the funding of the programs. Neither course will attract many supporters, I hope.

I hope also that my remarks about municipal unions will not obscure my support for decent wages and working conditions for municipal workers who face, as we all do, rising prices and shrinking disposable incomes. Certainly the vast majority of city employees are deserving people. But if a thing can be done, and it is profitable to do it, then it will be done. The unions have done it and they hope to do more of it.

The other corporation in American life, the business corporation, has done its share in bleeding the American city. While providing the investment that creates the jobs that make cities (which I recall is done for the corporation's profit and not *pro bono publico*) it takes every opportunity it can legally take to pass costs along to its municipal brother. This takes the form of whipsawing competitive jurisdictions for tax breaks, savaging municipal zoning ordinances, paying less than its fair share of municipal services, and more often than not leaving behind its problems when economic opportunities beckon from afar.

These activities of business (and higher level governments, who also leave cities many problems when they pull out or close down a facility) are not, most certainly, motivated by wickedness. They are the natural actions of self-interested organizations making rational choices in the absence of any municipal restraints on them. If a thing can be done, and it is profitable to do it, then it will be done.

Finally, in this litany of guilt, the role of the ordinary citizen must be mentioned. It has been at least two generations for many of us since our roots were so imbedded in a particular place that we felt responsible for it. We have, as always, our city boomers and hucksters and even our colorful characters (as New York City is alleged to have) but the city as an extension of self is largely gone. Our pleasures are mostly private pleasures now; we change cities as we change shirts, simply looking for the appropriate color and size. While we occupy a particular place, however, we vote on the election of its officers, the size of its budget and its capital building program. These decisions have implications for decades. We, meanwhile, have left for somewhere else. (The economist tells us the results are all reflected in the selling price of our house; I wish I had such faith in perfection on earth.

Certainly few will blame us for trying to secure a small corner of the economic city as a "nice place to live", to keep out "undesirables" or to force the city to which we commute to "take care of its own problems."

If a thing can be done, and it is profitable to do it, then it will be done.

Before turning to an examination of possible remedies I want to exempt one group from all but a small share of the blame, namely the municipal politician. While municipal corruption, like the poor, will always be with us, the main reason that many cities have remained as strong and vital as they have is the remarkably ability of some local politicians to make repeated saves, to find one more way to keep from going under, one more scheme to hold off the creditors. They are the latest in a long and honorable line of artful dodgers without whom, if I may remind you gentlemen, the Continental Congress would itself have gone under and taken the country with it. I admire and salute them. I do not, however, rest all of my hopes on them. There are things we can do that would help.

To start, we should mentally draw a line around the Northeast quadrant of the country, say at the Ohio and Mississippi rivers, coming east along the Ohio and Mason and Dixon line to the coast. Outside of this quadrant nothing much needs to be done about municipalities except to get off their backs. Certainly cities in the South, the Great Plains and the West have financial problems, but none that require any Federal action of unusual nature. Mostly what they need is to get back money that the Federal Government takes from them and to get it back in a totally unearmarked fashion. Most cities in these areas are working and working well. Some have even started that necessary reform, tax sharing across municipal boundaries. In particular, I call your attention to the metropolitan council of Minneapolis-St. Paul and its tax sharing program.

In the Northeast quadrant of the country lie all of our old industrial cities and most of our municipal finance problems. However, even in this area there are probably more financially well cities than there are sick ones, if fiscal health is measured as bankers would measure it.

So long, however, as any city, any city government, any municipal union, any agency of a city government, any bondholder or any resident thinks it likely that the Federal Government, like the Lord, will provide, then you can expect there to be more sick cities, in the Northeast quadrant and elsewhere. If a thing can be done, and it is profitable to do it, then it will be done.

Does that mean that present municipal crises are phoney? Not at all; it means that the cure must not infect the otherwise healthy. A historical example may illustrate the problem. As a result of state financial crises in some states in the 19th century, most states changed their constitutions so that the spending of money in many cases was dependent on various forms of referendum approval. Likewise, because of financial failure in some cities in the 20th century, many cities are limited in terms of bonded indebtedness and need voter approval for some kinds of expenditure. In addition, municipal bond experts designed various earmarked taxes and insulated certain other sources of revenue from the politician. All well and good, from the standpoint of the financial commuunity and the seller of municipal securities. Mostly bad for the political health of the community, as now two things happened. One, a host of special purpose, single interest agencies grew up that were financially self-sufficient at the expense of the general purpose government they were insulated from. The New York Port Authority is a notable case in point. It is at the same time a marvel in fiscal terms and an abomination in terms of citizen self-government. Its creators literally carved out a profitable sector of the public fisc and said the hell with everything else.

There are many such examples of letting the financial community decide where the private profit lies while leaving the unprofitable sectors to the general purpose governments, i.e., the cities and the taxpayers thereof.

The second thing that happened was that more and more problems were tossed up to the Federal Government since states and localities were constitutionally constrained from solving them. The only level of government that has no constitutional bars on its spending is the Federal Government. The only government tax that cannot be escaped by moving is the Federal tax. It was inevitable that most new programs would come from the Federal level.

Thus a reform that was designed to improve the performance of state and local governments ended by making them powerless to meet new needs. Similarly, reforms suggested today that would increase the hold of the investor over the local public fisc will, in my judgment, simply increase the move of municipal problems to the Federal level and further weaken the powers of state and local governments. These governments need to be stronger, not weaker; more independent, not less. If that provides a riskier capital market for the less prudent city managements, so be it. One of the best defenses a city can have in negotiations with its unions is the honest defence of the open market. A negotiator who can say, with truth, that a certain demand will make borrowing power suffer, hence the capital budget less, hence municipal jobs fewer, can hope, at least, not to be savaged by those who otherwise see a bottomless well from which to draw.

Where is reform needed? Mostly at the state level, since cities are the legal creatures of state power. What sort of reform? Reforms that recognize the economic boundaries of cities and relate the taxing power of the city to that boundary.

How could that be done? By rewriting the state laws governing municipal corporations, giving to any general purpose local government the right to levy taxes in adjacent communities (incorporated or not) whose residents are an economic part of the first community, the taxes to be proportional to the degree of economic dependence as measured by the work force.

Wouldn't that be impossible to find out? The information is in the 1970 Census of Population on a county level now and could easily be put on a Census tract basis in 1980.

How would the tax be levied, collected and distributed? In the same way that present taxes are levied, collected and distributed in many localities now, i.e., by the next higher level of government—the county or state (or in the future by a metropolitan council *a la* Minneapolis-St. Paul)—that allocates money to each local taxing unit within the area on the basis of its budget and legal sources of revenue.

Won't all the suburbs oppose such reforms? Some will, others know that they attract workers from the city and from farther out suburbs, thus they could gain from such a reform.

Are there reforms needed at the Federal level? Yes. (1) the formula for revenue sharing should reflect the place where people work as well as the place where they live, thus giving more revenue where it is needed and ending the perverse incentive for the proliferation of local governments now present in the formula. (2) The possibility of complete vesting of welfare rights at the individual level from Federal funds should be recommended to the relevant committees of the Congress as a necessary step in the assignment of appropriate revenues to problems. No longer should welfare be considered in any sense a local problem. In a Nation with no bars to internal migration it is a national problem and should have a national standard of support, operating through the negative income tax principle. (3) The concept of Federal grants-in-aid is long overdue for reform. Conceived as a way reluctant states and localities could be induced to initiate programs (and help to fund programs) of national concern, it has degenerated into a system of perverse incentives to get Federal money. (The lure of 90–10 highway money is irresistible to most states, regardless of their priorities.) Grants-in-aid should be replaced by outright and full Federal funding (and hence Federal control) over programs deemed to be in the national interest, with all other Federal funds channeled through general, unearmarked revenue sharing to states and localities. The present system distorts local priorities, confuses the public and dilutes public accountability.

Are there reforms that could be suggested at the local level? Perhaps, although nothing should be done to insulate municipalities against failure. In fact, I believe there should be more local bankruptcies, not fewer; that the possibility of fiscal mismanagement should be increased, not diminished, by higher levels of government. The only way that citizens will take a greater interest in local fiscal affairs is if it is in their personal interest to do so. Alexis de Tocqueville, writing more than a hundred years ago, said, "If . . . you do not succeed in connecting the notion of right with that of personal interest, which is the only immutable point in the human heart, what means will you have of governing the world except by fear?"

For that reason, I would hope to see fewer insulated special interest governments at the local level, more powers and more money given to the general purpose local governments, and rather free rein for them to succeed or fail. The spectre of general collapse of local governments because of venal politicans spending beyond the city's means is not one that should frighten this Republic on the eve of its 200th birthday. Nothing argues so strongly for good local government as the failure of a bad one. I hope we will always allow the bad ones to fail, "pour encourager les autres."

One of the men who helped to found the country said, "Those who would be free must be willing to bear the burdens of liberty." One of those burdens is the possibility of fiscal failure at the local level.

[Whereupon, at 11:25 p.m., the subcommittee adjourned, to reconvene at 9:45 a.m., Thursday, June 26, 1975.]

FEDERAL RESPONSE TO FINANCIAL EMERGENCIES OF CITIES

THURSDAY, JUNE 26, 1975

House of Representatives,
Commerce, Consumer,
and Monetary Affairs Subcommittee
of the Committee on Government Operations,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:45 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Robert F. Drinan, Elliott H. Levitas, David W. Evans, Edward Mezvinsky, and Willis D. Gradison, Jr.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Wanda J. Reif, counsel; Eleanor M. Vanyo, assistant clerk; and Lawrence T. Graham, minority professional staff, Committee on Government Operations.

Mr. Rosenthal. The subcommittee will be in order.

We will continue this morning our inquiry into the financial plight of American cities, with New York City being foremost.

We are honored this morning that the distinguished Secretary of the Treasury, the Honorable William Simon, can join us and give us the views of the administration, the Treasury Department, his own views, and what we might expect in terms of responsiveness and responsibility to this very acute problem.

Mr. Secretary, I know you have a prepared statement. We shall be pleased to hear from you.

STATEMENT OF WILLIAM E. SIMON, SECRETARY, DEPARTMENT OF THE TREASURY; ACCOMPANIED BY RALPH M. FORBES, SPECIAL ASSISTANT TO THE SECRETARY (DEBT MANAGEMENT); AND ROBERT A. GERARD, DIRECTOR, OFFICE OF CAPITAL MARKETS POLICY

Mr. Simon. Thank you, Mr. Chairman. I have a rather lengthy statement. I shall read as much as I can and summarize as much as I can.

I think for background we have to understand the nature of the problem that was developing in New York City. This is a very important point.

Frequently, corporate entities of all types find that the timing of receipts and expenditures do not correspond. Thus, for example, a builder will borrow money from a bank to build a house, promising to repay the money out of the proceeds of its sale to the homeowner. At the corporate or governmental levels, wider options are available. Because the amounts involved are often beyond the capacity of one bank—or even a group of banks—to lend from their own funds, such borrowing may take place through the sale of debt securities in the public market.

The successful use of this system depends on one simple condition: that the amount borrowed does not exceed the anticipated income. When this condition is continually violated—when, for example, borrowing occurs not in anticipation of income, but instead to close a gap between income and expenditures—the system ultimately breaks down. And that is precisely what happen to New York City this spring.

Having borrowed to finance deficits and then lacking a surplus in later periods to pay off these loans, the only way New York could pay off past loans was by floating new ones. As the deficits persisted and grew, the borrowing pyramid mounted: since 1969, New York's short-term debt has increased from $700 million to over $4 billion. At the end of 1974, New York accounted for nearly 40 percent of all State and local short-term debt outstanding.

The decision to halt this spiral was not made by a small group of men in a smoke-filled room. Instead, it was made in the clear light of day—visible to all—by that most omniscient of judges: the market itself.

On March 13 and 20, the city, through its underwriters, offered for public sale $912 million of short-term notes at tax-exempt interest rates of up to 8 percent. Even for investors of relatively moderate means this looked, at least on the surface, like a very good deal. For such investors, the effective yield, on a tax equivalent basis, was some three times greater than that available at a savings bank. Yet weeks after the offering, despite relatively vigorous marketing, more than half of the notes remained unsold.

The market had spoken. Investors knew that buying the notes would make them just another layer in the borrowing pyramid and that their primary source of repayment would be the creation of still more layers of debt in the months ahead. In the absence of any credible indication from the city that it was taking any action to balance its budget, the necessary first step toward undoing the pyramid, investors simply shied away, choosing instead from a variety of competing investment options. Although the returns on such instruments may not have matched what New York was offering, the risks as perceived by the market were much lower. For New York, the market—at least temporarily—had closed.

It was in this atmosphere that the U.S. Government entered the picture. When the possibility of a financial crisis was first brought to my attention in March, I immediately asked Under Secretary for Monetary Affairs Jack F. Bennett to take personal charge of the matter. Mr. Bennett—also a New Yorker by professional background—moved quickly. Within the first week alone he convened and participated in four high-level meetings—three here in Washington and one in New York City—involving representatives from the city, from the State and from the financial community. Indeed, at the last of this early series of meetings, he asked for and obtained the participation of experts on the municipal market from throughout the country.

To summarize, I describe the available options to meet this problem, our months of work with the city and State officials at all levels, investigating the HEW situation, options of revenue sharing, advance medicaid payments, and we go on at some length on this subject because we have been accused of callous insensitivity.

I would hope the time and effort we spent on this problem would show this is not true.

Mr. ROSENTHAL. One thing I am interested in—on pages 8 and 9 you said an early roadblock was the absence of good records. No document existed which summarized with any clarity the income and expenses of the city. Then you went on to assert that fact in a more eloquent manner.

Is this a fair statement of the situation?

Mr. SIMON. Yes, Mr. Chairman. This has been documented by others as well. The accounting system in New York City does not lend itself to complete clarity insofar as being able to look at their balance sheets and, within a reasonable period of time, get some semblance of understanding. We needed a lot of additional facts from them.

Mr. ROSENTHAL. For some time before you assumed your present position and before you came into government you had been chairman of the underwriting team that recommended securities and purchases for the city. Is that correct?

Mr. SIMON. I was chairman of the Technical Debt Management Committee which advised Mayor Beame when he was comptroller of New York City on methods of financing the city's debt.

Our problems were not directly, and our functions were not directly, related to the overall budget problems, although our conversations——

Mr. ROSENTHAL. What I am trying to ascertain is this: During the time you had that rather important professional position, were you satisfied with the city's accounting system, balance sheet mode of operation?

Mr. SIMON. There again the functions of this Technical Debt Management team were primarily directed right to how to market the New York City debt obligations, how that best could be done at the lowest interest rate to the city.

Mr. ROSENTHAL. I understand that. It would seem to me that if I had been in that position one of the things that would have been a useful tool in a successful marketing is a nice clean balance sheet.

Mr. SIMON. This was not the function of our committee. The Budget Commission and others dealt with the fiscal problems of New York City.

Let me now turn to the question of special Federal financial assistance to the city of New York. The determination that hundreds of millions of dollars would not magically materialize from HEW programs illustrates a fundamental proposition that we established very early. Irrespective of the merits of the case for special Federal financial assistance to New York, the practical means of providing such assistance were severely limited. We identified four possible options for the Federal Government:

One: Advance revenue sharing and medicaid payments.

Two: Guarantee or purchase New York securities.

Three: Lend New York City all or a portion of the required funds through the Federal Reserve System.

Four: Take no action at the Federal level, recognizing that a solution must be developed and implemented at the local level.

In evaluating the options, we first looked at the legality and practicality of implementing each of them, again still not yet reaching the question which separated options one through three from option four: That is, whether any form of Federal action was warranted on the merits.

As you know, we had no authority to make any direct loan to New York City nor purchase any of its securities. The fact is that medicaid advance payments and revenue sharing would come to such a small amount of money it would not even begin to meet its problems.

Governor Mitchell spoke yesterday on the option of a Federal Reserve loan.

With all of these considerations in mind we turn squarely to the merits of Federal involvement. In addressing this question, a number of criteria were relevant:

First, the assistance had to be effective: That is, it had to be part of a solution which we would confidently predict would prevent a recurrence of the crisis after this money ran out.

Second, the assistance had to be fair and equitable. We could not show undue favoritism to one city at the direct or indirect expense of others.

Finally, and this is partially a composite of the preceding criteria, the assistance had to be in the national interest. Undue expense or adverse impact on other Federal programs or objectives could not be tolerated.

What did effectiveness mean? It meant to us that the payment must be necessary to get the city over a nonrecurring, short-term crisis, a financial accident, so to speak. A payment would not be effective if it appeared that the same cash flow problem—highlighted by an inability to raise funds through the sale of securities in the public market—would appear again, month after month. A payment would not be effective if it treated only the symptoms and not the cause. In other words, we were looking for a plan of responsible fiscal action, designed and implemented at the local level, to restore investor confidence and reopen the public market. Although many ideas were discussed between March and the middle of May, as of the time of our decision, no city official was willing to commit the city government to an immediate and effective program of meaningful fiscal reform.

The importance of a program of fiscal reform really bridges this criterion of effectiveness and the next criterion of fairness. For if we were to use the Nation's funds to deal with the difficulties of one city, albeit a very important one, we would have to satisfy ourselves that any such payment would not be to the disadvantage of other cities.

Fairness meant two things. First, any aid we provided New York would have to be made available to other cities. Thus, nationwide application of option one, for example, would cost the Federal taxpayer

$15 million advance to medicaid and revenue sharing—a high price to pay for providing New York with a single $196 million payment.

Second, we looked at New York's position relative to other cities to determine whether it was demonstrating the kind of concern for its financial affairs that characterized the actions of other municipalities throughout the Nation. We immediately discovered that by comparison to other cities, New York was not a particularly hard-hit victim of the recession or the so-called urban crisis. Its real property values, its sales taxes, and its income tax revenues had held up better than most other cities. Unlike other cities, the problem was on the expenditure, not the revenue, side.

It is not the province of a Federal official to tell any city how much it should spend on social services, how much it should pay its employees, or charge its students. But when that city comes to Washington seeking financial aid, it is most emphatically the duty of the Federal Government to review the balance between expenditures and revenues. And what we found in New York was a complete lack of balance—rapidly increasing expenditures that far outstripped the growth in revenues. Expenditures were increasing at a rate of 15 percent a year while revenues were growing at only 8 percent a year. This problem is not merely too much government; it is financial disaster.

With this in mind, let me turn briefly to some specific data concerning the city's finances. Looking at the payroll, Census Bureau data shows that New York employs some 49 employees per 1,000 residents. The payrolls of most other major cities range from 30 to 35 employees per 1,000 inhabitants. And Baltimore, New York's closest competitor at 42 employees per 1,000, this year imposed a 20-percent reduction in the municipal payroll. By comparison, New York's proposed cuts—prior to Mayor Beame's recent budget announcements—were minimal.

Turning to specific services, New York spends $151 per capita on health and hospitals. Among other cities, only Boston is over $100, at $122 per capita—most cities are at $50 or below. Yet, as measured by the vacancy rate, nearly one quarter of the beds in New York City hospitals were empty last year.

I do not want to belabor the welfare situation; New York's problems in this regard are altogether too well-known. Nevertheless, it bears noting that among cities over 1 million—all of which have large underprivileged populations—only New York spends more than $20 per capita on welfare and related social services. Its figure is $315 per capita.

Moreover, although the situation has improved in recent years, the welfare rolls remain laden with ineligibles. Earlier this week the State department of social services reported an estimated ineligibility rate of 9 percent. Although this is down from 18 percent in 1973, the improvement still compares unfavorably with results elsewhere in the State. Over the same period, non-city welfare ineligibles fell from 15 percent to less than 1 percent. And these figures take on more meaning at over $10 million per percentage point.

Let's look at still other areas. At an annual cost of more than one-half billion dollars, New York's city-operated university—larger than virtually every State university—provides a tuition-free education to every high school graduate, regardless of the student's ability to finance his own education. Yet reasonable tuition charges would not be a hardship since both the State and Federal Governments have extensive scholarship programs, insuring that no qualified student will be denied an education. The present system needlessly subsidizes, at great expense to every taxpayer, those who are able to bear the costs themselves.

The burden of New York's massive payroll is multiplied by one of the Nation's most generous employee benefits systems. Fringe benefits for many city employees equal 50 percent of base pay. In addition, employees need not contribute to their own pension plans, yet may retire early at high rates.

Police and fire, sanitation, housing, the picture is the same: New York is at or near the top in every category on a per capita basis. And on a total dollar basis, to which we ultimately must turn in determining how the bills will be paid, there is simply no comparison.

As would be expected, the bottom line reflects the component parts. New York spends in excess of three times more per capita than any city with a population over 1,000,000. When the base is broadened to include smaller cities, only Boston and Baltimore spend more than half as much as New York—and even when compared to these cities, New York's expenses are 50 percent higher.

These figures, from 1973, provide the most current basis of comparison. When historical data are evaluated, other interesting trends come to light. Not only does New York now spend far more than any other city, but over a 10-year period its increase in spending has far outpaced other urban centers. From 1963 through 1973 per capita municipal expenses of large U.S. cities, excluding New York, increased on the average of 2.2 times. During the same period, New York's expenses increased some 3.5 times, a 50-percent greater rate.

The only way an entity which spends more than it takes in can keep afloat is by borrowing. Accordingly, the ultimate indicator of a city's ability to manage its financial affairs is its debt structure, and—given legal restrictions—particularly the short-term portion thereof. On June 30, 1969, New York had $671 million in short-term debt outstanding. By June 30, 1974, the figure had increased six times, to approximately $3.5 billion. And only the closing of the market for New York in April prevented the short-term borrowing load from approaching $6 billion this year. As it is, and taking into account State advances to be repaid by "Big MAC," short-term debt will be nearly $4.5 billion, a billion dollar increase in 1 year.

And even the growth in short-term debt does not tell the whole story. In recent years, some $700 million per year of deficit spending for current purposes has been hidden in the capital budget to be financed by long-term borrowing. This practice alone now costs the New York taxpayer well in excess of $100 million a year.

By contrast, apart from bond anticipation notes—which can be considered a form of construction financing—few cities have any short-term debt at all. Each year, Chicago issues some $300 million in notes, and pays them off annually when tax payments come in. Until May 5 of this year, Boston had $65 million in tax anticipation notes outstanding, but it retired them on schedule when 1975 taxes were paid this April. Again, except for bond anticipation notes, no other major American city reported any short-term debt.

In recent years, New York has faced the marketplace's demands for restraint, responsibility, and realism with spending, promises, and gimmickry. Capital borrowing for current expenditures, artificially high revenue estimates to balance budgets and support even more borrowing, and above all, an inability to say no where more spending is concerned, make New York unique among our major cities.

While the economic difficulties of recent years have caused most of us—from the individual taxpayer to other large cities—to tighten our already tight belts, New York has plunged onward, committing its own citizens to impossibly large financial burdens and now turning to the taxpayers of the Nation for even more funds.

In the course of numerous meetings at all levels, we stressed this disturbing set of facts to city officials. And we were not alone. From the New York Times, from the New York Clearing House, from the Citizens Budget Commission, the same message was repeated again and again: Get your spending into line with your ability to pay.

To summarize again, I describe the practical and political difficulties Mayor Beame faces in an attempt to cut the budget. They are akin to the political difficulties we face here when we attempt to do the same thing.

I talk about the meeting that the President, Mayor Beame, and Governor Carey held, where another exhaustive discussion of the problems took place.

I talk about the psychological effect of a possible default on the market. Such effect is difficult to determine precisely and must be a matter of individual judgment.

We discussed these questions at great length, and the Federal Reserve staff prepared papers on the economic impact as well as impact on municipal securities market and, indeed, on all capital markets.

There were differences of opinion. Some market professionals felt the effect of a default could be quite severe. Treasury and Federal Reserve bank personnel believed there would be a psychological impact—there is no doubt about that—but not quite as devastating an impact as some others felt. I must reiterate that this is a matter of individual judgment based on the experience of the people involved.

It was also believed uniformly that any default would be short lived. Sometimes we focus a little too much on the question of default as if that were a certainty. In this instance, default certainly is not a certainty. There are measures that New York can take, and indeed seems to be taking, right now to put their long-term house in order. That is what is required as the solution.

I talk of the effects on the banking system insofar as the securities of New York City being held by the New York City banks are concerned noting that such holdings were slightly less than 1 percent of their total assets.

While there again, there could have been a psychological effect in the event of a default, it is the function of the Federal Reserve to produce reserves in the event withdrawals created a liquidity problem.

We looked at potential consumer and business reaction, concluding that given general knowledge of New York's situation and an awareness that at least many of the underlying problems were of the city's own making, there was little risk that a default would be viewed as an indication of a more widespread economic malaise.

Under our system of government, it is not, and should not be, the job of the Federal Government to manage the finances of State and local government. That function must be handled locally, by the government's duly elected leaders. But we do have a responsibility to those leaders not to undermine their efforts. And if we have provided funds to New York, what would we have said, for example, to the mayor of Detroit or to the mayor of Cleveland, each of whom has incurred the wrath of major political forces in his own city by taking steps to see that they pay their own way. No; if our system is to continue to function, it was clear we had to protect the credibility of local leaders. And aid to the one major city which had not taken action to meet its fiscal responsibilities would have destroyed that credibility overnight.

These were the elements of our decisionmaking process. As you can see, the decision was not made hastily, lightly, or without complete attention to all relevant considerations. It was not an easy decision, but I think events to date have shown it was the right one. With the Federal avenue closed off, so to speak, all parties could again turn their full attention to developing a solution at the appropriate governmental level.

Before concluding, I do want to mention what the city and State have done since May 14, because I think it does provide a basis for optimism. The formation of the Municipal Assistance Corporation—or "Big MAC" as it has come to be known—provides the basis for constructive action in two important areas. First, MAC will refinance, and thus in effect reduce, New York City's short-term borrowing load by some $3 billion. A major problem in marketing New York City notes has been sheer volume, the market simply gets tired of the same issuer making massive claims on the market, month after month. Although New York's short-term borrowing demands will continue to be enormous by any standard, a reduction should be of benefit.

Second, both in the directives of the legislation itself and in the ongoing activities of the MAC board, valuable assistance in implementing a meaningful program of fiscal reform should be provided. The legislation directs the city to adopt reforms such as better accounting and the elimination of capital borrowing for expense items. Perhaps more importantly, the legislation makes the MAC board a formal participant in the budgetmaking process. As such, the largely nonpolitical board can act as a buffer for the other participants in making and implementing hard decisions with respect to spending which are essential to a long-term solution.

In short, MAC has helped with the cash-flow crisis, MAC will reduce the short-term borrowing load and MAC can provide needed technical and political assistance in making the necessary spending cuts. But the fact remains that the hard decisions must be made. And they must be made and implemented promptly to avoid a recurrence of the financial crisis in the fall.

Frequently over the past 3 months, the inevitable comparison between the finances of New York and the finances of the Federal Government has come up. The comparison is justified. The problem and its causes are the same, only our Federal printing press relieves us of one of the symptoms—the "cash-flow crisis." More importantly, the solution is the same: fiscal responsibility.

In tracing for you today the development and reasoning that led to our decision of May 13 with regard to the city of New York, I have tried to avoid pinpointing responsibility on any individuals or administrations. There is no need to descend to that level. More than that, I would hope that all of us might recognize that the New York City experience raises questions that are much larger than any individual personalities, questions that relates to our philosophy and approach toward government.

Americans are rightfully concerned about the fiscal plight of the largest and richest city in the land because they know that the philosophy which has prevailed in New York—the philosophy of spend and spend, elect and elect—first took root and flourished here in Washington, D.C.

As a Nation, we began planting the seeds of fiscal irresponsibility long ago. Forty of our last 48 budgets have been in deficit, and 14 out of the last 15. By the end of next fiscal year, the total Federal debt will be more than twice what it was less than a decade and a half ago. And by that same date, private holdings of Treasury securities will have increased 50 percent in only 18 months.

Neither man nor government can continue to live beyond their means for very long. A family that persists in such habits will eventually enter bankruptcy. A city will ultimately default on its loans. And a nation will foist upon its citizens the cruelest and most regressive tax of all, inflation.

There can be no doubt that the problems of inflation that we have experienced in recent years as well as the recession which arose from that inflation are both a product of our excesses of the past.

When the Federal budget runs a deficit year after year, especially during periods of high economic activity such as we have enjoyed over the past decade, it becomes a major source of economic and financial instability.

The huge Federal deficits of the 1960's and 1970's have added enormously to aggregate demand for goods and services, and have thus been directly responsible for upward pressures on the price level.

Heavy borrowing by the Federal sector has also been an important contributing factor in the persistent rise in interest rates and to the strains that have developed in money and capital markets. Worse still, continuation of budget deficits has tended to undermine the confidence of the public in the capacity of our Government to deal with problems such as inflation.

We must stop promising more and more services to the public without knowing how we will pay for them. We must play fair with the American people, telling them not only what services we can deliver but how much they will cost—both now and in the future. And we must recognize that the taxpayer, on whom the entire pyramid of Federal, State, and local taxation must rest, can carry only so much. It is fruitless to spend more than he is able or willing to pay for.

For too many years, like the city of New York, we have been trying to burn the candle at both ends, living off our inheritance and mortgaging our future at the same time. Whether we can prevent the Nation from falling into the same plight as our greatest city is now the central issue before us.

Mr. ROSENTHAL. Thank you very much, Mr. Secretary, for a very enlightening position—not surprising but certainly well thought out. I think it articulates the position with which you have been publicly identified.

Just talking about the city budget a moment, you cite essentially the only basis for the refusal to cut expenditures has been a lack of political courage. That is the implication I draw from your statement.

Did you also examine, consider, or look into what effect the kinds of cuts you would recommend would have on loss of services to citizens in either New York or any other city?

Mr. SIMON. I never felt, Mr. Chairman, that it was the function of a Federal official to make recommendations to a State or municipality on the specifics of what they should cut or how they should spend or where they should spend it. I think it is entirely up to the State and local officials to make those determinations. They are much more familiar with what their priorities are and what their needs are than a bureaucrat in Washington.

Mr. ROSENTHAL. How do you respond to the assertion made by Mayor Beame, and I think others in the city, that the city is really the recipient of the Federal Government's problems and has, in fact, been assuming Federal burdens for 20 or 25 years?

For example, there are 1 million illegal aliens in New York City requiring services. Most of them are there because the Federal Government has not fulfilled its responsibilities.

There are a million people on welfare, many who migrate to the cities because the communities they came from, for various reasons, were less attractive to them. In other words, the burdens the city has are not of the city's making.

How do you respond to that assertion?

Mr. SIMON. I am not so sure that I agree with it entirely. I have heard the fact there are a million, or whatever the number is, it is a different number every time I hear it, illegal aliens in New York City. I don't know how to quantify that number. I think it is a Justice Department responsibility, Immigration Service, to make sure illegal aliens don't come into the United States; period. This applies to New York City and the Southwest.

Mr. ROSENTHAL. The Customs Department says they cannot do the job because the Government will not give them the money. That is what the Commissioner of Naturalization has done.

Mr. SIMON. I was not aware this was a revenue problem.

Mr. ROSENTHAL. It is. They have testified time and time again they don't have enough money to hire enough agents to do anything about the problem. Therefore, for various reasons New York City picks up the responsibility for the failure of the Federal Government.

Mr. SIMON. How can illegal aliens get welfare payments if they know they are illegally in the city?

Mr. ROSENTHAL. There are actually two different problems, one is welfare and the other illegal aliens. They get hospital services, school services, other social services. They receive services. There is no question about that.

Mr. SIMON. As far as welfare payments, you know you get to a fundamental question here which really is outside my purview, the Federal Government's responsibility to assume welfare payments in any large city.

Is that a Federal problem or local problem? That goes well beyond the present problem of expenditures, the way they have capitalized their operating expenses and the general problem they face.

Every family faces problems like this. They would like to do all of these particular things. They take a look at their revenues and they have to make some difficult decisions.

Mr. ROSENTHAL. Does the administration have any program or plan for assisting cities in financial difficulties, either through direct payment or assistance in marketing their securities?

Mr. SIMON. At present there are many economc development programs but they are not directed to that type of assistance. We have HUD and the other payments, as you well know. However, as far as providing direct financial assistance, no, sir.

Mr. ROSENTHAL. This morning the Washington Post carries a story "U.S. Weighing Insurance for Municipals." The first paragraph states:

> The Ford Administration is considering a proposal to provide Federal insurance for municipal bond offerings that could cut borrowing costs for financially hard-pressed cities like New York by hundreds of millions of dollars because the Government was underwriting the risk.

Are you familiar with this proposal?

Mr. SIMON. This is a proposal that I think Felix Rohayton of Lazard Freres made to have a sort of Federal Government insurance program for municipal bonds. There are private entities which now insure municipal securities.

I understand from an article I read recently that these private entities have been meeting the need for insurance in this area. However, this proposal was made just this week, Mr. Chairman.

Mr. ROSENTHAL. Is it moving along with some serious consideration?

Mr. SIMON. Of course we will give it serious consideration. We will look at the pros and cons, the need for insurance at the Federal level for this type of financing. You have to identify the scope of the problem. It cannot be for just New York City but for all the State and local financing involved, whether it is necessary, what the cost of such insurance will be. Yes; it is indeed moving seriously.

Mr. ROSENTHAL. In the face of declining demand by commercial banks and insurance companies for municipal tax exempts how will the cities market their debts in years to come?

Mr. SIMON. The cities have not had that much difficulty in marketing their debts. They have suffered just as everyone suffered from high interest rates caused by the high inflation rate. While it is true there are other tax advantages available to all business entities which cause a decline on the part of the commercial banking system in their holdings of municipal securities, they are still substantial purchasers of municipals. And any gap has been filled by individuals and other buyers.

I will supply for the record, Mr. Chairman, the percentage of municipal securities that are owned by all classes of investors.

[The information referred to follows:]

OWNERSHIP OF MUNICIPAL SECURITIES

As of December 31, 1974, $207 billion of State and local government debt (both long and short term) was outstanding. Of that amount, commercial banks held $99.8 billion or 48%, households (i.e. individual investors) held $62.3 billion or 30%, non-life insurance companies held $31.5 billion or 15%, and the remaining $13 billion was held by corporations, pension funds, mutual savings banks and similar entities.

Moreover, in light of the recent assertions to the effect that institutional interest—specifically commercial bank interest—in holding State and local debt is declining, it is useful to look at the historical trends. In 1965, commercial banks held 39% of the then $100.3 billion outstanding. By 1970, the banks' percentage had grown to 48% and has remained relatively constant since then.

Mr. ROSENTHAL. Yesterday, I think it was the president of the Federal Reserve bank in Boston, who said that the municipal bond market and underwriting market was—I am trying to find the exact words—he said was in total disarray. He said the municipal bond market is in disarray.

Mr. SIMON. There is a feeling now in the marketplace, whether right or wrong remains to be seen, that the Fed has decided to moderate its posture of monetary expansion. This has caused unrest in all capital markets, especially where there are heavy inventories. Such instability occurs in all capital markets every time the Fed watchers, and all market people are Fed watchers, think they see a change in policy.

Mr. ROSENTHAL. Mr. Frank Miles, President of the Federal Reserve Bank of Boston, said:

The temporary source restraint is a shock to investor confidence in municipal bonds stemming from the financial difficulties of New York City which in turn has affected the ability of many other cities to obtain financing at reasonable terms.

That is the point we are trying to make, not only that New York solicits help, but is the difficulty caused by New York's problem going to cause difficulties throughout the country? Mr. Miles suggests yes.

Mr. SIMON. That is a matter, as I said in my testimony at some length, of individual judgment as to the psychological effect on the marketplace. There is no denying the fact there is, in the event of default, a psychological effect. The good credit risks, which have been borrowing in the municipal market for many years, still would be able to obtain funds.

You have to remember that you are assuming by that question that New York City will be a permanent defaulter, a permanent problem. That is not the point at all because New York City has it within its means, and New York State has, to build a bridge.

Now they have Big MAC. We saw the rally that occurred in the market after the announcement of Big MAC, giving the city time to put its fiscal house in order. I think that is the road to a solution, but they have to make the difficult decisions.

Again I don't want to be insensitive to these problems, but we cannot attack the symptoms of problems and not the causes. Now it looks like New York may attack these causes and make those extremely painful and difficult—and they are political—decisions. You know the problems, Mr. Rosenthal.

Mr. ROSENTHAL. Congressman Drinan.

Mr. DRINAN. On page 16, Mr. Secretary, you speak about the Federal Reserve. We did have, as you know, Governor Mitchell here.

I am wondering whether there was any serious discussion with the Board of Governors or the Federal Reserve about the possibility of giving a loan to New York City.

Mr. SIMON. Indeed there was. I did not attend the Governors' meeting of the Federal Reserve when this was brought up. Arthur Burns, however, and George Mitchell, on occasion, were present in all of the economic group's discussions on the plight of New York City. In addition, under Mr. Bennett's supervision, the Federal Reserve prepared the papers on the economic impact and the potential market impact, because they are extremely sensitive to conditions in the capital markets and the possible instability that could occur.

Mr. DRINAN. Were there any requests by the administration to the Federal Reserve to do everything they could to give such a loan?

Mr. SIMON. We asked them to look at this option and present us with the position of the Federal Reserve Board applicable to aiding all cities, because such aid could not be confined to New York City.

Mr. DRINAN. Do you think they have any power? You seem to concede they have the power.

Mr. SIMON. Yes, under the Federal Reserve Act it implicitly——

Mr. DRINAN. Why haven't they used it in 40 years? Do you think they are wrong?

Mr. SIMON. No, sir; I do not.

Mr. DRINAN. Why do they have it if they are not using it? Congress gave it under these stringent circumstances, but it seems to me odd that in 40 years they have never used it. There have been crises in cities. There have been situations which Congress contemplated but the Board of Governors of the Federal Reserve have never used the power given them. It seems unusual.

Mr. SIMON. Let's talk about it in the context of the notion about attacking the results rather than the causes.

Mr. DRINAN. That is not the point. Congress authorized this power. Congress said five members of the Board are needed for a vote—more than a simple majority—and the power has to be utilized with extreme restraint, but in 40 years they have never used the power given by Congress.

The burden is on them to show that it is too stringent or that these circumstances do not exist. If ever circumstances existed in 40 years we have it in New York City. Yet neither the administration nor the Federal Reserve said "We have the machinery under these circumstances to act."

Mr. SIMON. The very fact Congress specified that five of the seven Governors must be in agreement shows the intent of Congress that the authority should be limited to really extraordinary circumstances.

Mr. DRINAN. Did they ever have a record vote denying it to New York City?

Mr. SIMON. I would refer the question to the Fed. I don't know the answer. I was assured they were in agreement in denying any aid for this.

You get to the fundamental point about what our central bank is in the United States.

Mr. DRINAN. It has the power, Mr. Secretary. Congress gave it the power to act in a situation like this. That is all I am saying. The burden is on them.

Frankly, Governor Mitchell did not carry the burden yesterday of proving that even under these extraordinary circumstances we cannot exercise the power we have.

We don't have to get to what you say, what this is for. The Federal Reserve has this power and it has not utilized it.

Mr. LEVITAS. I believe yesterday, during the course of Mr. Mitchell's testimony, I made the observation to him with which he concurred—that the requirements imposed by the statute are such that anybody who could meet those criteria obviously would not need to borrow money, anyhow. If they could there would be many private banks very happy to lend them with fully secured loans with Federal securities as collateral.

It seemed to me, if I recall Mr. Mitchell's response yesterday, that in order for a city to qualify for a loan of that type they had to be in a position not to need the loan to begin with.

That is his interpretation.

Mr. GRADISON. Governor Mitchell's testimony yesterday indicated there were five conditions which had to be met, that New York City would meet three of them.

First, unusual circumstances existed. Second, potential borrowers have exhausted other sources of funds. Finally, the failure to use Federal Reserve credit which would have serious impact on the rest of the Nation.

Finally he indicated New York City did not meet two of the five tests—borrower insolvency and inadequate collateral, the borrowers need is for short-term accommodation, and its basic financial condition to permit early repayment.

I would like to suggest that Governor Mitchell made it clear yesterday that it was his understanding, and he indicated this was discussed by the Board of Governors, New York City did not meet the statutory test.

Mr. DRINAN. Are they statutory tests or regulations of the Federal Reserve?

Mr. GRADISON. The statement indicated all five tests had to be met.

Mr. SIMON. Also, we had a great wrangle among the attorneys who said there was doubt whether Congress intended to make such loans available to cities. The language in the statute is ambiguous, but you can always find counsel that will see your side.

Mr. DRINAN. On pages 21 and 22 you suggest that there is a great maladministration of hospital beds in New York City.

Mr. SIMON. I was not suggesting that. I suggested there was a surplus.

Mr. DRINAN. The vacancy rate is nearly one-quarter of the beds empty last year. Is that high?

Mr. SIMON. Yes, it is.

Mr. DRINAN. On another point before I yield to Mr. Gradison, on page 23 you speak about the CCNY. Is there any way around the regulations at the Federal level, without forcing every student to apply for a scholarship and get money that way? Is there some way to waive that and to say that a certain number of students are entitled to scholarships and they do not have to apply, and if New York City wants to keep this great tradition of a free university there will be a certain bending of Federal bureaucracy so as to give a certain amount based upon the number of students who can be calculated to deserve it and waive the business of the students actually applying for it?

Mr. SIMON. I would have to look at that regulation to find out whether or not there is any latitude there.

Also in New York State I am told they have a very generous scholarship program which can be made to New York City to alleviate the burden for those who cannot afford to pay tuition.

Mr. DRINAN. Rightly or wrongly they have pride in the fact this is a free university. Furthermore OMB never funded the capitation grants funded by Congress for 2 or 3 years. That clearly would be one way. They could get x amount for every student at the school.

There is a program where Congress authorized it expressly and where the OMB and this administration and the previous administration are in total defiance of the will of the Congress.

Mr. SIMON. If you mean impoundments——

Mr. DRINAN. Not impoundments but they have not recommended these. OMB said every year, "We will not give capitation grants," even though that passed Congress. That would be one way. You could give relief to CCNY in this way.

I yield to Mr. Gradison.

Mr. GRADISON. Mr. Secretary, I know that you have been concerned, as many of us have been for some time, about the impact of cumulative Federal deficits on the ability of the private economy to raise adequate funds to provide jobs, and the term "crowding out" has crept into the jargon of our times.

Most of that discussion is focused on the possibility of crowding out private borrowers and private industry.

Is it not possible, too, that large Federal deficits and substantial Federal borrowings could make it more difficult for other borrowers, such as State and Federal Governments, to obtain loans?

Mr. SIMON. Yes. I never confine my comments to just the private sector.

As you well know, we have a ladder of borrowers in the private sector. The Federal Government, due to its high quality rating, is right at the top of that ladder. We always have the advantage in the capital markets. There are always more demanders than suppliers. The disadvantage to others grows and it grows from the bottom up—housing suffers, State and local governments suffer, small businesses, consumers.

They suffer on two fronts, either the credit is not available or the interest costs are too high.

Mr. GRADISON. To some extent the Federal Government has compounded this problem, if not for New York, for any marginal borrower.

Mr. SIMON. There is no doubt about that.

Mr. GRADISON. Mayor Beame's testimony——

Mr. SIMON. We compound the problem by causing inflation. That starts it.

Mr. GRADISON. Mayor Beame's testimony, as I listened to it, seemed to run along this line:

That he had been controller and was aware of gimmickry—that was his term—in the financing of the city of New York.

When he became mayor a year and a half ago he proceeded to try to straighten this thing out.

He felt, as I understood him, he was making good progress along those lines when all of a sudden, and this was his phrase, he referred to a "cash boycott" which was imposed by somebody or other on him.

As I listened to him he felt it was unfair because, after all, he took so many important steps over a year and a half to correct the acknowledged weaknesses of the city's finances.

As a former mayor myself I felt some sympathy with his problem but I wondered about the facts.

You were involved. Do you have any impressions about whether such substantial changes have been made over the last year and a half?

Mr. SIMON. I think the bankers in New York City, and outside of New York as well, should not be criticized for not doing enough. If anything, they should be criticized for doing too much. We have to look at the record.

It is important to understand the function of the banks. They are not just buying these securities for themselves and living off this lush, so-called lush, income, tax-exempt income. They are buying them as investment bankers, just as private capitalized investment banking firms purchase these securities. They purchase them, hopefully, to sell them at a profit.

When New York City issues a large issue, as I said in my testimony, at 8-percent, tax-exempt interest, an extraordinary tax-exempt rate of interest, and the banks cannot sell it, they lose because they are not in the business of paying high money rates to carry these securities and not resell them. They have other commitments, broad commitments in the financial markets, including corporate borrowers, the Federal Government, State governments, and so on.

When they cannot sell the securities at 8 percent, a higher interest rate will not attract people. Just go back to the Penn Central a few years ago when they could not be marketed at 9 or 10 and finally investment bankers talked about 11 percent. This alarms people.

When an interest rate that high has to be charged something is fundamentally wrong. If something is wrong people will go to the alternative. There is no scarcity of securities in the marketplace to buy. Everyone is borrowing at extraordinary levels today—the Federal Government, State and locals, corporate financing at an alltime high. There is plenty of choice for people. They don't have to take unnecessary risks.

Mr. GRADISON. There was some discussion in our earlier hearings which drew an analogy with the FDIC, I think it was, about the possibility of the Federal Government's stepping in with guarantees.

We also had references to guarantees in the private market. Some of these are done through MGIC in more recent years.

Also there was reference made by Congressman Rosenthal a few moments ago to the article in the Washington Post.

There is one paragraph here he did not read and it is important. It states: "A city would first have to put its financial house in order and regain a reasonable credit rating in order to qualify for the insurance."

All my experience suggests that, for a financial institution to obtain the insurance backing of the FDIC or savings and loans, from the FSLIC, or for a community to get support from MGIC in the private market in the insurance of their securities, they first have to have everything in pretty good shape.

I think it is important to get this point out. Simply having a new entity created, whether it is Federal or State, will not relieve the pressure on the local government to straighten out its affairs. Indeed it will increase the pressure as a condition for the borrowing.

I am sure "Big MAC" itself is not doing this from the goodness of its heart because the credit of the State of New York could be impaired if this were not set up on a basis which would permit "Big MAC" to meet its obligations.

Coming back to some of the suggestions we have made here before by Mayor Beame and others, that the Federal Government should in some way guarantee the credit of all State and local governments. I think we have to look a little further and recognize, no matter who is writing the program, it will not be done without the most stringent conditions.

At that point we would get into questions as to whether in a given community—whether New York or anywhere else—whether people should get free water, 50-percent pension after 20 years' service, very highly subsidized subway fares, and so on. Those specifics then would come up.

The things we don't want to get into because they should be decided by the elected officials in the country would necessarily be the business of the local or State officials if they were to back the credit of some other entity. There is no way to avoid it.

Mr. Simon. That is the important point. If you want insurance you have to do all these things. If you did all those things you wouldn't need insurance. You would have access to the marketplace. That is the point.

Are we talking about the Municipal Assistance Act of 1975 where it is the function of the Federal Government to assist State and local governments to remove this very important discipline and, if you will, encouraging irresponsibility on the expenditure side? That is the decision for the Congress.

I think that State and local governments, New York City, my State of New Jersey, have spoken explicitly in their constitutions stating that the budget must be balanced. This is a necessary discipline on everyone. It is in the national interest.

Mr. Gradison. Thank you, Mr. Chairman.

Mr. Drinan. Thank you, Mr. Gradison.

Mr. Secretary, I may have to leave because I have another meeting. Clarence Kelley of the FBI is there, and I have many more quarrels with him than with you.

Mr. Simon. I am glad to hear that. I am sorry for Clarence Kelley.

Mr. Drinan. I will ask Mr. Levitas to preside.

Mr. Levitas. Thank you, Mr. Chairman.

One of the additional quirks of the new Congress, Mr. Secretary, is that a freshman Member of the Congress can have seniority on subcommittees over our more revered senior Members of Congress. That is one of the consequences we will all have to suffer with today.

I have one or two questions which I would like to put to you.

However, as background to that, let me be sure I understand your position. On pages 7 and 9 of your testimony you make what I consider to be a rather scathing indictment of the fiscal mismanagement of New York City over the past number of years. You talk about the way in which their expenses have increased so rapidly as compared to other municipalities and talk about the vast increase in their short-term borrowing.

Then you make the point, as I understand it, that the really critical problem in New York City in its short-term borrowing, that it was not using this short-term borrowing to make up the gap in cash flow in anticipation of tax collections but, in fact, was using it as a permanent part of its budget. Is that basically your position?

Mr. Simon. First of all, Congressman, we tried and we rewrote this statement about seven times to attempt not to be per se scathing but to present a measured factual account of the fiscal problems of New York City, what happened over the 5 years, and why they find themselves in this terrible difficulty at this time.

Of course, the major portion of this difficulty derives from the management of their finances: How they transferred operating expenses into the capital budget, which obviously increases the cost to the taxpayers in New York City, how their revenues have increased at one-half the rate of their expenditures. Sooner or later this must lead to severe financial problems.

Then I tried to compare New York City with other major cities, with Boston, Cleveland, Detroit, Philadelphia, and others around the country to make sure we were being fair. We tried to be fair and yet be as comprehensive as we could and not scathing.

Mr. LEVITAS. Those recitations of the facts there, don't you believe they constitute an indictment of the affairs of the city of New York?

Mr. SIMON. I don't know whether I would use the word "indictment." Surely it illustrates that fiscal management has been irresponsible. I am not alone when I make that statement.

Mr. LEVITAS. I am not suggesting you are alone. I think what you are saying, and it should be stated squarely, is that you are suggesting that the management of the fiscal affairs of the city of New York over a period of time has been, I think you used the word "irresponsible."

Mr. SIMON. Yes.

Mr. LEVITAS. That has manifested itself with the current problem they are having—they cannot sell their short-term notes to the public. Is that correct?

Mr. SIMON. Yes, sir.

Mr. LEVITAS. Mayor Beame, when he testified before this committee earlier, alluded to a point that Mr. Gradison touched upon in his questioning. He said that these problems which have led the banks to stop purchasing the short-term debt obligations are not new, that they have existed for a period of time. They were well known to the officials of the city of New York and they were well known to the bankers, presumably, who were purchasing their obligations.

He raises the question of why they stopped now. Didn't, as you say, they do too much and lead New York City down the primrose path? I relate that specifically to your Department's regulatory responsibilities and the function of the Treasury Department and the Comptroller of the Currency.

As I understand it, the Comptroller of the Currency has regulatory jurisdiction over many of these banks which were buying these debt obligations at a time when they should not have been buying these debt obligations, not just this year but in past years.

How would you respond to that?

Mr. SIMON. Let me talk a little about what I said. That is why, adding to what Mr. Gradison said, I said if anything the banks should be criticized for going too far, rather than for not doing enough.

The important point is that it was not the bankers that made a callous decision to stop purchasing New York City securities. The market did. The bankers, including investment bankers, such as the firm I worked for in New York City—purchase the securities as investment bankers with their own money, for resale at a profit.

When those securities cannot be resold to institutional investors, individuals around the country, for all the reasons I mentioned, you are certainly not going to buy any more securities at higher rates. Therefore, it was not a group of banks or individuals but the market which denied New York City access to the market. Nobody can foresee when that will happen.

A few years ago, I don't remember the exact date, New York City floated a long-term bond issue to finance the back pay of firemen and policemen. This precipitated a reduction in their rating from AAA to BAA, which was a clear warning to the city that such practices, in that case, putting operating expenses into the capital budget, should not be followed.

These are practices that for a time people can get away with through various accounting methods, short-term debt, making up the difference in the deficit every year. Finally the market blows the whistle.

Mr. LEVITAS. The point I wanted you to speak to, though, was the fact that the bankers presumably are the experts in this field of anticipating when these problems will develop. Yet they remained silent.

At the same time they were holding and continuing to purchase these short-term securities of the city of New York with these problems extant in the fiscal structure and yet apparently the Comptroller of the Currency did nothing, made no comments about the quality of the paper that was being purchased, and the banks were continuing to purchase it up to the early part of this year.

Mr. SIMON. The Comptroller of the Currency could not conclude that the amount of bank ownership of New York debt—is slightly less than 1 percent of assets for the New York City banks—would cause a banking problem.

New York City banks were operating just like investment bankers and private firms in purchasing these New York City securities. They bought their limit.

New York bankers were not silent. They were meeting with city officials to warn them that one day they would have extraordinary difficulty in marketing their securities. In recent times New York City securities had gone increasingly to this group of small banks, and they were reaching their upper limit of how much of their assets they were willing to put into this one security.

As a result, when the public market was finally closed, this was the end.

Mr. LEVITAS. I notice in your testimony you refer to the projections and anticipation of what would follow from a default by New York City, projections made by Mr. Greenspan and the Council. Also, you were quoted in the New York Times of May 16 where you said that if New York City defaulted on its obligations, the impact on the national economy would be negligible.

I understood your oral testimony here to be somewhat different from that, that you did anticipate there could be some severe ramifications, at least in municipal bond markets.

Mr. SIMON. That is two different questions. One, we talk about the economy, two, the capital markets. It would not have had a significant impact insofar as the Nation's economy is concerned. It would have an impact psychologically and a direct impact on New

York City municipal obligations. There is no doubt about that. It would affect the municipal market to some extent for some time.

There again, the judgments vary as to what extent. However, again we are assuming a default and bankruptcy. I have never assumed this, because New York City had it within their power, and still does directly and through New York State, "Big MAC," to take the actions to prevent this.

Mr. LEVITAS. I would like to say that I fully agree with your assessment of the solutions to these problems. Those solutions are not to provide emergency short-term financing from the Federal Government without some hope that there will be an ultimate solution to the fiscal problems.

As long as the city of New York or any State and local government continually spends more than it takes in you are only exacerbating the problem by providing short-term financing rather than making the drastic decisions which have to be made to get the system back into balance.

I share Mr. Gradison's concern that a Federal commission dealing with this subject would carry with it the types of strings and controls which would end up letting a Federal bureaucrat run the cities of America——

Mr. SIMON. That is what would happen. I agree with you.

Mr. LEVITAS. I would be very loath to see that happen.

I take it from your testimony this morning, notwithstanding this article in the Washington Post, that you as an individual would have severe reservations about such a commission or corporation and would be an opponent of it within the considerations being made by the administration?

Mr. SIMON. I was an opponent of the Federal Government guaranteeing State and local securities, yes, for all the reasons mentioned, and I am sure I can think of a lot more as well.

As far as a Federal insurance program is concerned, we will look at that, seriously look at it.

There is, as I say, private insurance available right now. I must admit my first judgment on insurance is that the requirements a State and local government would have to meet to get insurance would be stringent enough so that any government which met them would not need insurance to finance in the markets.

Mr. LEVITAS. There would be too many strings attached to it.

Mr. SIMON. And you would get the Federal Government running State and local governments. We are doing too much of that already.

Mr. LEVITAS. Thank you, Mr. Secretary.

I yield to my colleague.

Mr. MEZVINSKY. Mr. Secretary, you made a statement that we caused inflation. I gather you are focusing upon the Government there.

Specifically the problem I see in New York and facing the country is productivity and jobs. With every increase in 1 percent unemployment it adds about $16 billion to our deficit in terms of lost revenues, unemployment compensation, and so on.

I am somewhat concerned that simply by putting the burden, which I think the Government has, on the urban areas, you will add to inflation. How do you answer that argument if each additional 1 percent unemployment could mean as much as $16 billion added to our budget deficit?

Mr. SIMON. First of all, when we say we refuse to help urban areas, a good portion of our budget here in the Federal Government goes to assist State and local governments, not only through the revenue sharing, that brandnew program of 2 years ago, but also through the grants and all the rest of the programs.

I shall supply for the record the total amount, but if memory serves me it is up to $60 billion of aid to State and local governments. We do not walk away from that responsibility.

[The information referred to follows:]

FEDERAL ASSISTANCE TO STATE AND LOCAL GOVERNMENTS

In fiscal 1976, the Federal government will provide $52 billion in direct categorical assistance to State and local government and an additional $6.3 billion in general revenue sharing. This $58.3 billion in direct Federal assistance represents a $12.3 billion increase over fiscal 1974 and is double the 1971 figure of $29.8 billion.

Moreover, these data do not even begin to show the actual Federal contribution to State and local economies. Under the 1976 budget, direct Federal assistance to individuals will be $135 billion. And billions more are returned to local economies through salaries of Federal employees, Federal purchases of goods and services, rental payments, etc.

Mr. SIMON. As far as unemployment, we continue to provide expanded unemployment programs to take care of this problem. There again, however, we are looking at the results of the problem and not the causes. It was inflation which caused the recession which caused high unemployment.

Let's take care of the unemployment in the United States and make sure that these people are not going to bear a disproportionate burden of our economic woes today, but at the same time let's attack inflation, get the economy back on a stable and prosperous course again where we can get back to full employment and price stability. That is the answer.

Mr. MEZVINSKY. Without belaboring the point, Mr. Secretary, I think the problem we are having now is whether to focus on the recession or on the inflation.

Mr. SIMON. We have to focus on both, but we cannot focus on only one and forget the other and thereby exacerbate the problems in the other area.

Mr. MEZVINSKY. How do you answer, then, on revenue sharing? It seems a lot of your testimony here points to the problems of New York and the problems of mismanagement. What do you propose for revenue sharing in terms of guaranteeing that the funds which go to the cities are directed toward the programs designed specifically to help inflation and to help productivity?

Mr. SIMON. This is the purpose of revenue sharing, that it is not the function of the Federal Government to dictate to the State and local governments what they should use these moneys for.

For years the Federal Government has been determining priorities to State and local governments. Then we concluded that State and local governments were better equipped to define their own priorities. Let them make the decisions at the State and local levels and not by a Federal bureaucrat who says, "You need a swimming pool" or "You need a firehouse" or you need some other thing. You make the decision back home.

Mr. MEZVINSKY. Why should we find ourselves in a situation where we make billions of dollars of loans and loan guarantees to private corporations and yet refuse aid to the cities such as New York facing fiscal emergencies?

Mr. SIMON. No. 1, Congressman, we don't make billions of dollars of loans to private entities. You refer to the Lockheed loan of a couple years ago, I assume, where the amount presently outstanding is approximately $200 million. It may be less than that right now.

That was an entirely different case. You do this on a case-by-case basis. I do not favor the Federal Government taking care of inefficiency whether it be in State or local government or corporations or anywhere else.

However, first, the amount in Lockheed's case was much smaller. Two, a Government cutback in defense contracts was having a temporary effect on the operations of Lockheed. They were suffering from a liquidity crisis. This liquidity crisis required some tough decisions and policy implementation on the part of this corporation which were immediately put into place. That is why the decision was made a few years ago to make this particular loan.

Mr. MEZVINSKY. Don't we have a situation where the FDIC guarantees banks that are in trouble? Don't we have the Agriculture Department forgiving a situation with Cargill? We have OPEC involved. You can go right down the line—look at agriculture, look at banks, and go right down the whole economy.

Mr. SIMON. I missed your point on OPEC. What was that?

Mr. MEZVINSKY. You have foreign investment situations with OPEC. You have Cargill involved in forgiveness. You have the FDIC looking at banks in trouble.

Mr. SIMON. Banks pay a premium for FDIC insurance. It is a self-funding operation. The function of the FDIC, indeed all the regulatory agencies that were established in the early 1930's, was to protect the American citizen and his savings, his life savings in many instances being held in banks.

The Fed lends banks money at interest and only when collateralized. Usually, as in the case of the Franklin National Bank, they build a bridge to merge the bank and liquidate it in an ordinary fashion.

Nobody makes money on this. The important thing is that the American depositor in these banks is protected. That is very important.

Mr. MEZVINSKY. What about the workers finding themselves out of jobs within the particular areas hit by the fiscal crisis?

Mr. SIMON. Unemployment is the severe penalty and price we are paying today as a result of our excesses of the past 10 years and the inflation which caused it. That is the inevitable result.

If we allow that double digit inflation to continue I suggest unemployment will go a good deal higher.

Mr. MEZVINSKY. That is really the thrust of the problem. We are to the issue of survival in terms of a job and what it means versus the problem of inflation.

Mr. SIMON. Exactly. How does one cure it? I am with you 100 percent—how do we cure this problem?

First we take care of these people paying this price through the massive unemployment programs we have in place.

Then we work on getting the economy back to the stable path again with low inflation rates. They will have jobs. That is what people want. They don't want Federal pay or State welfare payments. They want jobs and want to work. That is what we are trying to put into place.

Mr. MEZVINSKY. I don't think the quarrel is just with the Federal payout. The problem is that we really have a national emergency deeper than just the city of New York. It will compound itself, and previous testimony seems to indicate we just can't look at the city of New York. As you are aware, we very well have to look to many other places.

Therefore, I am concerned that if we basically accept the philosophy of letting the cities go it alone and we avoid the problem in the midst of this crisis, that we will see the problem build up to be even worse than it is today.

Mr. SIMON. We are not avoiding the problem, as I say, we give massive assistance, a very large percentage of our budget being directed to assisting State and local governments. However, it is not the function of the Federal Government to take over the running of the State and local governments.

Mr. MEZVINSKY. Is there available to you or any other official a comprehensive analysis of the fiscal emergencies facing other areas as well as New York and suggestions as to what the Federal Government should do about them? Have you been studying it?

Mr. SIMON. All of this data as far as State and local governments are available, yes.

Mr. MEZVINSKY. I am trying to pinpoint that. Rather than saying it is available, are you or is any particular agency involved in studying the city of New York problems, their ramifications and what the Federal Government should be doing in terms of long-range planning?

Mr. SIMON. We have determined this on a case-by-case basis. We went into this in great depth, as my testimony shows.

As far as doing an overall study on the finances and the economies of the individual States, we have not embarked on such a program in the Treasury Department. I don't know if any other Department of the Government is doing it.

Mr. MEZVINSKY. One of the greatest problems we see in the city of New York and around the country, you point to it in your testimony, is that of welfare and how to deal with it.

Have you yourself outlined and thought through what welfare reform programs should be directed to the city of New York and around the country? Have you tried to voice your sentiments to the President in advocating a welfare reform program to the Congress?

Mr. SIMON. Yes, we have worked for the last 2 years on welfare reform in the Government. The President has and will continue to focus on this very important issue nationwide—yes.

Mr. MEZVINSKY. Do you foresee a message or some kind of program or plan being submitted to Congress in the near future?

Mr. SIMON. I wouldn't know when the President would make a decision on this. This is a primary responsibility of HEW.

Mr. MEZVINSKY. I am aware of that.

Mr. SIMON. HEW will develop whatever comprehensive program is required. Obviously, as Secretary of the Treasury, I participate in these discussions because they have an economic impact and a financial impact.

Mr. MEZVINSKY. In view of your testimony don't you think that is very urgent in terms of being able to face the situation we are facing today in the future?

Mr. SIMON. I believe welfare reform is necessary, yes. I believe it for many reasons—one, that our present welfare programs are inefficient, overlapping. I think we can do more for the people who really need welfare with comprehensive welfare reform.

However, as you well know, the process is not over when the President decides which program he wants. It will not be a simple thing to get welfare reform through Congress.

Mr. MEZVINSKY. I want to say in my closing remarks that I come from a State which does not have a city like New York. I come from Iowa.

However, what disturbs me about the problem of New York, and I am sure it disturbs you, is that it has an effect which permeates the whole Nation. I am very disturbed as to how our Government will respond not only to the city of New York but how it will face similar problems in other communities around the country.

I think New York can face its problems but similar financial crises will occur in other cities and our Government will have to respond to them. I am afraid that if we simply let the urban areas go it alone, unemployment will increase and we will have further alienation from our political process.

For that reason I think it is a very severe problem. I know you testified on this, but I am still concerned as to what kind of Federal response we will have.

Mr. SIMON. There again, the purpose of my testimony this morning was precisely to deal with what we did and how we felt about New York City.

Our investigation of what is going on in those cities——

Mr. MEZVINSKY. That is why I asked what kind of comprehensive analysis you have made.

Mr. SIMON. We look at what other cities are doing, their expenditures, the number of city employees they have in Boston, Cleveland, and so on. We find State and local governments have responded to this problem by making tough political decisions that New York has not yet made, but more certainly will have to make in order to develop a long-term cure. That is what we are talking about, a long-term cure.

Mr. MEZVINSKY. When we have testimony from the League of Municipalities almost to a mayor coming in with problems——

Mr. SIMON. Of course, everybody always has problems. I can have my wife come up and testify about problems with finances. There we are down to the problem—should the Federal Government run State and local government? I guess my philosophy on this would not surprise you gentlemen at all. I believe in strong States. They should have the right to decide their own priorities. That will not be done by building a bureaucracy in Washington that will decide these things for you.

Mr. MEZVINSKY. I don't think we question bureaucracy. What we are questioning is high unemployment——

Mr. SIMON. Yes, sir.

Mr. MEZVINSKY. Which is tearing this country apart.

I have nothing further.

Mr. Evans?

Mr. EVANS. In your statement you mentioned some very incredible statistics on per capita spending by New York City on social services.

How much of this difference between what New York is spending on social services and what other comparable cities would be spending on social services, let's say comparable cities over 1 million population in this country, would you attribute to New York City's higher cost of living?

Mr. SIMON. We didn't do a cost-of-living analysis as far as New York City is concerned to the best of my knowledge. That would be easy to do. But even if New York City's cost of living is a few percentage points, and I would be surprised if it were any more than that, higher than other cities, that certainly does not justify the enormous differences in spending between New York and other cities.

When we look at all the cities of over 1 million people, all of which have large underprivileged populations, only New York spends more than $20 per capita on welfare. Their figure is $315. That is but one illustration. I have others in my testimony.

Mr. EVANS. How much of a factor would you say New York's size alone contributes to its expenditures?

Mr. SIMON. I don't know how to measure Los Angeles, whether I would include Los Angeles County or just the city. That is a city of comparable size and still growing. I think the welfare load in the city of Los Angeles is about $1 per capita. In Chicago it is $3 per capita. That is quite a comparison.

Mr. EVANS. On the last statement or two of your testimony this morning you talked about the Federal budget deficit. How long do you think it will be before the Federal budget is balanced? How much longer will we have to look at a serious budget deficit?

Mr. SIMON. When are we going to stop spending more than we earn, even when we get back to full employment and full employment revenues in the Treasury Department? It seems our propensity to spend outpaces our ability to earn the money to pay for it.

Mr. EVANS. You don't see that situation changing, then, in the foreseeable future?

Mr. SIMON. I see it changing. When I go back to my early testimony of December, January, February, and March of this year, when we had leaders of Congress and others giving astronomical guesses of budget deficits, George Mahon said $160 billion in fiscal 1976—we could have done anything with those numbers—I believed we would be at $100 billion in 1976. I no longer believe that, although the danger exists we could approach that. However, I think there is an awareness growing in Congress of the dangers of this excessive spending and the promises we continue to make to the people in America. Without the ability to pay for all of these programs it results in the cruelest, unlegislated tax of all, inflation. The American people do not like that and they should not. We have to start doing something about it.

For the rest of this decade we will have to make some awfully tough decisions. Let's face it, they are political decisions. When you cut spending in the Federal Government everybody's ox is gored.

One can say we ought to cut spending, but it doesn't help if for political reasons—to get reelected—he fights for spending programs. It is difficult to cut spending. I understand that. But we have to do it.

Mr. EVANS. Thank you, Mr. Secretary.

I have nothing further, Mr. Chairman.

Mr. MEZVINSKY. Mr. Secretary, we want to thank you. I think the feeling some of us have, almost the phrase that was used in another context, is a feeling of benign neglect. At least I walk away with that feeling.

However, I appreciate your testimony. I think you have given us some insight we should seriously consider.

Mr. SIMON. Thank you very much, Congressman.

[Mr. Simon's prepared statement follows:]

PREPARED STATEMENT OF WILLIAM E. SIMON, SECRETARY, DEPARTMENT OF THE TREASURY

A few years ago Charles De Gaulle arrived in New York and spoke affectionately about the special bonds he felt for that great City. "How often, at difficult moments, I look to New York, I listened to New York, to find out what you were thinking and feeling here, and always I found a comforting echo." Those of us who know New York City as the financial capital of the world, the focal point of its capital markets, have similar feelings. I have been privileged to spend my professional career there, and I look upon the city as a second home.

It was with these feelings that my colleagues and I approached the very difficult problems of New York this spring. There was no prejudice against New York, only a sadness that this great City which had inspired so many had allowed its finances to become so disordered. And there were certainly no prejudgments based on the coincidence that the city's leadership happened to come from a different political party. No, we faced the problems of New York City acutely aware that fundamental questions relating to the proper roles and responsibilities of government at all levels of our system were squarely presented. And we concluded that the problems of New York were created at the local level and would have to be solved there.

For background, we must first understand the nature of the problem that was developing. Frequently, corporate entities of all types find that the timing of receipts and expenditures do not correspond. Thus, for example, a builder will borrow money from a bank to build a house, promising to repay the money out of the proceeds of its sale to the homeowner. At the corporate or governmental levels, wider options are available. Because the amounts involved are often beyond the capacity of one bank—or even a group of banks—to lend from their own funds, such borrowing may take place through the sale of debt securities in the public market.

The successful use of this system depends on one simple condition: that the amount borrowed does not exceed the anticipated income. When this condition is continually violated—when, for example, borrowing occurs not in anticipation of income, but instead to close a gap between income and expenditures—the system ultimately breaks down. And that is precisely what happened to New York City this spring.

Having borrowed to finance deficits and then lacking a surplus in later periods to pay off these loans, the only way New York could pay off past loans was by floating new ones. As the deficits persisted and grew, the borrowing pyramid mounted: since 1969, New York's short-term debt has increased from $700 million to $4 billion. At the end of 1974, New York accounted for nearly 40 percent of all state and local short-term debt outstanding.

The decision to halt this spiral was not made by a small group of men in a smoke-filled room. Instead, it was made in the clear light of day—visible to all—by that most omniscient of judges: the market itself. On March 13 and 20, the City, through its underwriters, offered for public sale $912 million of short-term notes at tax-exempt interest rates of up to 8 percent. Even for investors of relatively moderate means this looked, at least on the surface, like a very good deal. For such investors, the effective yield, on a tax equivalent basis, was some three times greater than that available at a savings bank. Yet weeks after the offering, despite relatively vigorous marketing, more than half of the notes remained unsold.

The market had spoken. Investors knew that buying the notes would make them just another layer in the borrowing pyramid and that their primary source of repayment would be the creation of still more layers of debt in the months ahead. In the absence of any credible indication from the City that it was taking any action to balance its budget, the necessary first step toward undoing the pyramid, investors simply shied away, choosing instead from a variety of competing investment options. Although the returns on such instruments may not have matched what New York was offering, the risks as perceived by the market were much lower. For New York, the market—at least temporarily—had closed.

It was in this atmosphere that we entered the picture. When the possibility of a financial crises was first brought to my attention in March, I immediately asked Under Secretary for Monetary Affairs Jack F. Bennett to take personal charge of the matter. Mr. Bennett—also a New Yorker by professional background—moved quickly. Within the first week alone he convened and participated in four high-level meetings—three here in Washington and one in New York City—involving representatives from the City, from the State and from the financial community. Indeed, at the last of this early series of meetings, he asked for and obtained the participation of experts on the municipal market from throughout the country.

Our purpose in holding the early series of meetings was twofold. First, we wanted to determine quickly whether any facile steps were available to reopen the market in time to permit the City to sell $550 million of additional notes on April 14. Accordingly, we met and talked with a variety of market experts—from New York City and elsewhere—to identify the causes of the market closure and to explore possible solutions. These were candid, realistic meetings of professionals, urgently seeking ways to sell a then unsaleable product.

A second purpose of these early sessions related more directly to the question of Federal financial assistance. Before we could identify, much less evaluate, our options in this regard, we needed facts: facts about the City's expenses and obligations, facts about its revenue sources, facts about its debt structure. An early roadblock was the absence of good records. No document existed which summarized with any clarity the income and expenses of the City. No document provided a straightforward accounting of its assets and liabilities. As we quickly became mired in the byzantine world of the City's accounts, our requests that such information be developed were met with earnest promises of prompt compliance. Although that was more than three months ago, the information has not yet arrived.

While these meetings proceeded, other parts of our staff were also at work. Our legal staff analyzed questions ranging from our legal authority to purchase municipal securities to the coverage of the federal bankruptcy laws. Others began to explore in depth the range of federal assistance programs. And after complaints surfaced that payments under our social and educational assistance programs were too low or too late or both, we immediately commenced an inquiry at HEW, which has responsibility for administration of the programs involved.

Let me dwell briefly on the HEW situation because it is indicative of the kind of misunderstanding which has permeated this entire matter. At the City's request, senior members of my staff and Secretary Weinberger's staff met with budget experts from the relevant departments of the City's government: The Board of Education, the Department of Social Services and the like. Understandably, there was an element of suspicion at the start, fueled by a conviction that somehow the Federal Government was shortchanging the City in the amount and timing of its support payments. As the meeting progressed a strange thing happened: in going through the assistance programs, item-by-item, the group determined that HEW was doing an excellent job in scheduling its assistance payments to New York. Apart from a question whether certain Medicaid payments should be changed to an advance rather than reimbursement basis—which I shall discuss later—the City officials left satisfied that we were properly carrying out our responsibilities.

But HEW's concern for New York did not stop there. After the meeting, they carefully reviewed our entire program in New York, most of which is administered through the New York State Department of Social Services. And that review resulted in the discovery of substantial underpayment of the estimated federal welfare payments paid to the City by the State. We called the under-estimates to the attention of appropriate State officials, and the matter was promptly corrected, with the City receiving an additional $90 million.

I call these matters to your attention because they so clearly belie the image of callous insensitivity that some have sought to saddle us with.

Let me now turn to the question of special federal financial assistance to the City of New York. The determination that hundreds of millions of dollars would not magically materialize from HEW programs illustrates a fundamental proposition that we established very early. Irrespective of the merits of the case for special federal financial assistance to New York, the practical means of providing such assistance were severely limited. We identified four possible options for the Federal Government:

One: Advance Revenue sharing and Medicaid payments

Two: Guarantee or purchase New York City securities.

Three: Lend New York City all or a portion of the required funds through the Federal Reserve System.

Four: Take no action at the federal level, recognizing that a solution must be developed and implemented at the local level.

In evaluating the options, we first looked at the legality and practicality of implementing each of them, again still not yet reaching the question which separated options 1 through 3 from option 4: that is, whether any form of federal action was warranted on the merits.

We found that only the first option could be accomplished by Executive Branch administrative action. We had no authority whatsoever to make a direct loan to New York or to purchase any of its securities. As a matter of law, there were only two sources of meaningful amounts of cash.

First, there was Revenue Sharing. On July 7, we are scheduled to make the April–June quarter's Revenue Sharing payment. New York City is scheduled to receive $64 million and New York State an additional $57 million. Had we advanced the date for making this payment and had the State then agreed to turn over to the City all of its share, this source could have provided $121 million.

The other potential source of cash was the change in the Medicaid payment method I referred to earlier. At present, the federal share of Medicaid coverage for patients in private hospitals is paid to cities on a reimbursement basis; that is, upon presentation of a voucher confirming that the city has paid the hospital the amount in question. As a consequence, the city must first borrow the funds and pay the hospital before receiving the federal share. Had we changed this procedure, agreeing to provide the funds in advance on an estimated basis, we could have provided the City with approximately $75 million from this source.

The total of $196 million available through these channels seemed small in relation to New York's enormous cash requirements. We therefore tended to dismiss this option and turned to the others.

New legislation—the second route—appeared equally unpromising. Legislation authorizing federal purchase or guarantee of municipal securities raises a number of complex issues ranging from tax policy to management of the Federal Debt to federal/state/local relations. In view of the fact that any such legislation would—as a political necessity—have had wider application than just New York City, such complexity alone eliminated this course as a viable option. There simply was not time to resurrect and resolve these fundamental questions in a satisfactory way and still meet New York's timetable for cash.

Third, there was the possibility of a loan from the Federal Reserve. Governor Mitchell addressed this option in detail yesterday and I need not retrace his steps. In evaluating this option from the Administration's standpoint, however, these facts stand out. First, we were aware of the limitations Congress itself imposed on this approach. By requiring the approval of five members of the Board of Governors—more than a simple majority—Congress clearly intended that this authority be exercised with extreme restraint. Moreover, we knew that historically the Fed had conformed to the will of the Congress and had not exercised such authority in nearly four decades. Accordingly, we were aware from the start that this option, like the first two, was probably of dubious utility.

With these considerations in mind, we turned squarely to the merits of Federal involvement. In addressing this question, a number of criteria were relevant:

First, the assistance had to be *effective:* that is, it had to be part of a solution which we could confidently predict would prevent a recurrence of the crisis after this money ran out;

Second, the assistance had to be *fair* and *equitable:* we could not show undue favoritism to one city at the direct or indirect expense of others;

Finally, and this is partially a composite of the preceding criteria, the assistance had to be in the *national interest:* undue expense or adverse impact on other federal programs or objectives could not be tolerated.

What did effectiveness mean? It meant to us that the payment must be necessary to get the City over a nonrecurring, short-term crisis, a financial accident, so to speak. A payment would not be "effective" if it appeared that the same cash flow problem—highlighted by an inability to raise funds through the sale of securities in the public market—would appear again, month after month. A payment would not be effective if it treated only the symptoms and not the cause. In other words, we were looking for a plan of responsible fiscal action, designed and implemented at the local level, to restore investor confidence and reopen the public market. Although many ideas were discussed between March and the middle of May, as of the time of our decision no City official was willing to commit the City Government to an immediate and effective program of meaningful fiscal reform.

The importance of a program of fiscal reform really bridges this criterion of effectiveness and the next criterion of fairness. For if we were to use the nation's funds to deal with the difficulties of one city, albeit a very important one, we would have to satisfy ourselves that any such payment would not be to the disadvantage of other cities.

Fairness meant two things. First, any aid we provided New York would have to be made available to other cities. Thus, nationwide application of option 1, for example, would cost the federal taxpayer $15 million—a high price to pay for providing New York with a single $196 million payment.

Second, we looked at new York's position relative to other cities to determine whether it was demonstrating the kind of concern for its financial affairs that characterized the actions of other municipalities throughout the nation. We immediately discovered that by comparison to other cities, New York was not a particularly hard-hit victim of the recession or the so-called urban crisis. Its real property values, it sales taxes and its income tax revenues had held up better than most other cities. Unlike other cities, the problem was on the expenditure, not the revenue, side.

It is not the province of a federal official to tell any city how much it should spend on social services, how much it should pay its employees or charge its students. But when that city comes to Washington seeking financial aid, it is most emphatically the duty of the Federal Government to review the balance between expenditures and revenues. And what we found in New York was a complete lack of balance—rapidly increasing expenditures that far outstripped the growth in revenues. Expenditures were increasing at a rate of 15 percent a year while revenues were growing at only 8 percent a year. This problem is not merely too much government; it is financial disaster.

With this in mind, let me turn briefly to some specific data concerning the City's finances. Looking at the payroll, Census Bureau data shows that New York employs some 49 employees per 1,000 residents. The payrolls of most other major cities range from 30–35 employees per 1,000 inhabitants. And Baltimore, New York's closest competitor at 42 employees per 1,000, this year imposed a 20 percent reduction in the municipal payroll. By comparison, New York's proposed cuts—prior to Mayor Beame's recent budget announcements—were minimal.

Turning to specific services, New York spends $151 per capita on health and hospitals. Among other cities, only Boston is over $100, at $122 per capita—most cities are at $50 or below. Yet, as measured by the vacancy rate, nearly one quarter of the beds in New York City hospitals were empty last year.

I do not want to belabor the welfare situation; New York's problems in this regard are altogether too well-known. Nevertheless, it bears noting that among cities over 1,000,000—all of which have large underprivileged populations—only New York spends more than $20 per capita on welfare and related social services. Its figure is $315 per capita.

Moreover, although the situation has improved in recent years, the welfare rolls remain laden with ineligibles. Earlier this week the State Department of Social Services reported an estimated ineligibility rate of 9 percent. Although this is down from 18 percent in 1973, the improvement still compares unfavorably with results elsewhere in the state. Over the same period, non-City welfare ineligibles fell from 15 percent to less than one percent. And these figures take on more meaning at over $10 million per percentage point.

Let's look at still other areas. At an annual cost of more than one-half billion dollars, New York's city-operated university—larger than virtually every state university—provides a tuition-free education to every high school graduate, regardless of the student's ability to finance his own education. Yet reasonable tuition charges would not be a hardship since both the state and federal governments have extensive scholarship programs, insuring that no qualified student will be denied an education. The present system needlessly subsidizes, at great expense to every taxpayer, those who are able to bear the costs themselves.

The burden of New York's massive payroll is multiplied by one of the nation's most generous employee benefit system. Fringe benefits for many city employees equal 50 percent of base pay. In addition, employees need not contribute to their own pension plans, yet may retire early at high rates.

Police and fire, sanitation, housing, the picture is the same: New York is at or near the top in every category on a per capita basis. And on a total dollar basis, to which we ultimately must turn in determining how the bills will be paid, there is simply no comparison.

As would be expected, the bottom line reflects the component parts. New York spends in excess of three times more per capita than any city with a population over one million. When the base is broadened to include smaller cities, only Boston and Baltimore spend more than half as much as New York—and even when compared to these cities, New York's expenses are 50 percent higher.

These figures, from 1973, provide the most current basis of comparison. When historical data are evaluated, other interesting trends come to light. Not only does New York now spend far more than any other city, but over a ten-year period, its increase in spending has far outpaced other urban centers. From 1963 through 1973 per capita municipal expenses of large U.S. cities (excluding New York) increased on the average 2.2 times. During the same period, New York's expenses increased some 3.5 times, a 50 percent greater rate.

The only way an entity which spends more than it takes in can keep afloat is by borrowing. Accordingly, the ultimate indicator of a city's abiilty to manage its financial affairs is its debt structure, and—given legal restrictions—particularly the short-term portion thereof. On June 30, 1969, New York had $671 million in short-term debt outstanding. By June 30, 1974, the figure had increased 6 times, to approximately $3.5 billion. And only the closing of the market for New York in April prevented the short-term borrowing load from approaching $6 billion this year. As it is, and taking into account state advances to be repaid by "Big Mac," short-term debt will be nearly $4.5 billion, a billion dollar increase in one year.

And even the growth in short-term debt does not tell the whole story. In recent years, some $700 million per year of deficit spending for current purposes has been "hidden" in the capital budget to be financed by long-term borrowing. This practice alone now costs the New York taxpayer well in excess of $100 million per year.

By contrast, apart from bond anticipation notes—which can be considered a form of construction financing—few cities have any short-term debt at all. Each year Chicago issues some $300 million in notes, and pays them off annually when tax payments come in. Until May 5 of this year, Boston had $65,000,000 in tax anticipation notes outstanding, but it retired them on schedule when 1975 taxes were paid this April. Again, except for bond anticipation notes, no other major American city reported any short-term debt.

In recent years, New York has faced the marketplace's demands for restraint, responsibility and realism with spending, promises and gimmickry. Capital borrowing for current expenditures, artificially high revenue estimates to "balance" budgets and support even more borrowing, and, above all, an inability to say no where more spending is concerned, make New York unique among our major cities. While the economic difficulties of recent years have caused most of us—from the individual taxpayer to other large cities—to tighten our already tight belts, New York has plunged onward, committing its own citizens to impossibly large financial burdens and now turning to the taxpayers of the nation for even more funds.

In the course of numerous meetings at all levels, we stressed this disturbing set of facts to City officials. And we were not alone. From the New York Times, from the New York Clearing House, from the Citizens Budget Commission, the same message was repeated again and again: get your spending into line with your ability to pay.

How did the City respond? Speaking bluntly, I think they thought we were all a bit naive. You could fight crime, you could fight pollution, you could fight poverty and ignorance, but—in New York—you could not underestimate the powerful forces for spending being brought to bear on the City's elected officials, driving the City into the slow and painful death of bankruptcy.

Now I know enough about New York to know that Mayor Beame and his colleagues would be in the fight of their lives the moment they touched their scalpel to the growing layer of fiscal fat which is strangling the City. One only has to look at that incredible pamphlet off-duty policemen, firemen and others were handing out to tourists earlier this month to appreciate the kind of problem the Mayor was dealing with. But we make a tragic mistake when we resolve questions solely on the basis of which side is more threatening or more unscrupulous.

But as of early May, when I, and then the President, met with the Mayor and the Governor, no resolution of the problem was in sight. The issue as then presented was plain and simple: give us the money to get us through the immediate crisis, then we'll begin to worry about a solution.

As I have indicated, it had become clear that the only real solution lay in a responsible program of fiscal reform. Such a program would reopen the market and avert the possibility of a default by New York City. But because no such program had even been suggested by City officials, it was our responsibility to evaluate the constant suggestions that a default by New York would have a devastating impact on the capital markets, the banking system and the national economy as a whole.

It was quickly apparent that the principal adverse effects would be based on psychological factors, not objective ones. To be sure, many parts of the economy—especially in New York City—would suffer severe harm. On the whole, however, our markets, our banking system and our economy each are large and diversified enough to withstand the temporary inability of even an entity the size of New York City to meet its obligations.

But I have been around markets long enough to know that one ignores psychology at his own peril. Accordingly, before reaching a decision, we asked ourselves three more questions about the psychological effects of a default:

First, what impact would a default have on the securities markets, particularly the municipal markets?

Second, would a default influence the condition of the major banks?

And third, what impact would a default have on public confidence nationally?

With respect to the impact on the market, it is fair to say that there were differences of opinion. Certain market professionals from the private sector did tell us the effect could be devastating. But my staff and the Federal Reserve Bank of New York, which as you know, serves as the focal point for our public securities markets, advised me that whatever impact did occur would be temporary, and, even so confined, would be negligible.

Three factors produced this judgment. First, it was uniformly believed that any default would be shortlived and that there was enough underlying value in New York City to assure that all holders would eventually be paid 100 cents on the dollar. Second, the municipal market had recently experienced the prospect of a major tax-exempt issuer default—New York State's U.D.C.—and had weathered it well. Third, New York's problems had been public knowledge since at least November and the market, at least in large part, had reflected this risk by discounting the prices of New York City and other weaker issuers. This last judgment was confirmed by the strong rally in the municipal market when "Big Mac" was established.

We found the banking system even better equipped to handle whatever shock might occur. The New York City holdings of the major New York banks, while large in absolute terms, were only a fraction of one percent of the total assets of these institutions. The sophisticated investors, whose large deposits were in question, were aware of this fact, and were also aware that, upon a default, this portion of the banks' holdings of New York securities would hardly become worthless.

This lack of a realistic basis for fearing large withdrawals was coupled with a recognition that the system was designed to handle such an event, if it did occur. A primary reason for establishing the Federal Reserve System was to correct temporary imbalances of liquidity in our banking structure. And the

System clearly would have been able to handle any imbalance which might have occurred in these circumstances.

Finally, working with Chairman Greenspan of the Council of Economic Advisors and senior economists at the Federal Reserve, we looked at potential consumer and business reaction. In view of the general knowledge of New York's situation and an awareness that at least many of the underlying problems were of the City's own making, we saw little risk that a default would be viewed as an indication of more widespread economic malaise.

Concluding that a default would not have precipitated an economic crisis did not mean that a default should not be avoided at virtually any cost. But when we reviewed our analysis of what other cities have done and are doing to meet the economic challenges of these times, another barrier to special treatment for New York became apparent. Many of our leading cities are having troubles these days, troubles largely attributable to the recession and unemployment levels, and to the impact of these phenomena on municipal revenues. But as I discussed earlier, and as confirmed by a recent Joint Economic Committee staff study, virtually all these jurisdictions have met their problems head on, recognizing that meaningful cuts in spending levels were a critical part of any solution. As we in this town are altogether too aware, spending cuts do not come easy for any elected official, especially when a direct impact on one's own constituents can be identified. But throughout the country, brave local leaders have literally put their political futures on the line by insisting that all questions, however painful, be addressed and that the problems be solved in a responsible manner.

Under our system of government, it is not, and should not be, the job of the Federal government to mange the finances of State and Local government. That function must be handled locally, by government's duly elected leaders. But we do have a responsibility to those leaders not to undermine their efforts. And if we have provided funds to New York, what would we have said, for example, to the Mayor of Detroit or to the Mayor of Cleveland, each of whom has incurred the wrath of major political forces in his own city by taking steps to see that they pay their own way. No, if our system is to continue to function, it was clear we had to protect the credibility of local leaders. And aid to the one major city which had not taken action to meet its fiscal responsibilities would have destroyed that credibility overnight.

These were the elements of our decision-making process. As you can see, the decision was not made hastily, lightly or without complete attention to all relevant considerations. It was not an easy decision, but I think events to date have shown it was the right one. With the Federal avenue closed off, so to speak, all parties could again turn their full attention to developing a solution at the appropriate governmental level.

Before concluding, I do want to mention what the City and State have done since May 14, because I think it does provide a basis for optimism. The formation of the Municipal Assistance Corporation—or "Big Mac" as it has come to be known—provides the basis for constructive action in two important areas. First, MAC will refinance, and thus in effect reduce, New York City's short-term borrowing load by some $3 billion. A major problem in marketing New York City notes has been sheer volume, the market simply gets tired of the same issuer making massive claims on the market, month after month. Although New York's short term borrowing demands will continue to be enormous by any standard, a 40 percent reduction should be of benefit.

Second, both in the directives of the legislation itself and in the ongoing activities of the MAC Board, valuable assistance in implementing a meaningful program of fiscal reform should be provided. The legislation directs the City to adopt reforms such as better accounting and the elimination of capital borrowing for expense items. Perhaps more importantly, the legislation makes the MAC Board a formal participant in the budget-making process. As such, the largely non-political Board can act as a buffer for the other participants in making and implementing the hard decisions with respect to spending which are essential to a long term solution.

In short, MAC has helped with the cash-flow crisis. MAC will reduce the short-term borrowing load and MAC can provide needed technical and political assistance in making the necessary spending cuts. But the fact remains that the hard decisions must be made. And they must be made and implemented promptly to avoid a recurrence of the financial crisis in the fall.

Frequently over the past three months, the inevitable comparison between the finances of New York and the finances of the Federal government has come up.

The comparison is justified. The problem and its causes are the same, only our Federal printing press relieves us of one of the symptoms—the "cash-flow crisis" we have just experienced. More importantly, the solution is the same: fiscal responsibility.

Ladies and Gentlemen: In tracing for you today the developments and reasoning that led to our decision of May 13 with regard to the City of New York, I have tried to avoid pinpointing responsibility on any individuals or administrations. There is no need to descend to that level. More than that, I would hope that all of us might recognize that the New York City experience raises questions that are much larger than any individual personalities, questions that relate to our philosophy and approach toward government.

Americans are rightfully concerned about the fiscal plight of the largest and richest city in the land because they know that the philosophy which has prevailed in New York—the philosophy of spend and spend, elect and elect—first took root and flourished here in Washington, D.C. As a nation, we began planting the seeds of fiscal irresponsibility long ago. Forty of our last 48 budgets have been in deficit, and 14 out of the last 15. By the end of next fiscal year, the total Federal debt will be more than twice what it was less than a decade and a half ago. And by that same date, private holdings of Treasury securities will have increased 50% in only 18 months.

Neither man nor government can continue to live beyond their means for very long. A family that persists in such habits will eventually enter bankruptcy. A city will ultimately default on its loans. And a nation will foist upon its citizens the cruelest and most regressive tax of all, inflation.

There can be no doubt that the problems of inflation that we have experienced in recent years as well as the recession which arose from that inflation are both a product of our excesses of the past. When the Federal budget runs a deficit year after year, especially during periods of high economic activity such as we have enjoyed over the past decade, it becomes a major source of economic and financial instability. The huge Federal deficits of the 1960s and 1970s have added enormously to aggregate demand for goods and services, and have thus been directly responsible for upward pressures on the price level. Heavy borrowing by the Federal sector has also been an important contributing factor in the persistent rise in interest rates and to the strains that have developed in money and capital markets. Worse still, continuation of budget deficits has tended to undermine the confidence of the public in the capacity of our government to deal with problems such as inflation.

We must stop promising more and more services to the public without knowing how we will pay for them. We must play fair with the American people, telling them not only what services we can deliver but how much they will cost—both now and in the future. And we must recognize that the taxpayer, on whom the entire pyramid of Federal, state and local taxation must rest, can carry only so much. It is fruitless to spend more than he is able or willing to pay for.

For too many years, like the City of New York, we have been trying to burn the candle at both ends, living off our inheritance and mortgaging our future at the same time. Whether we can prevent the nation from falling into the same plight as our greatest city is now the central issue before us.

Mr. Evans. We shall continue next with Mr. Petersen.

I would like to welcome you to our subcommittee and ask you to proceed with your testimony.

STATEMENT OF JOHN PETERSEN, WASHINGTON DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. Petersen. I am John Petersen. I am testifying on my own behalf and my individual views are not necessarily those of the Municipal Finance Officers Association for whom I am the Washington director and economist.

In my written statement, which I have submitted, I give a review of the economic conditions and their impact on the fiscal performance of the State and local government sector from 1970 through the present.

The statement's emphasis is on the shift in financing requirements, particularly for capital outlays, and the growing difficulties of balancing the budgets that State and local governments are experiencing and ramifications of this for the capital markets.

This morning I would like to review the present situation in the municipal bond market and the availability of funds to State and local tax-exempt bonds from key investor groups.

Also I will touch on what I believe are the salient issues surrounding possible forms of Federal credit assistance to State and local governments.

The deepening deficit position for that sector, which we see today, roughly about $15 to $16 billion deficit for general governments, is causing governments to reach out for many alternatives to close the budget deficit. In many cases they are raising taxes or they are trying to expand other revenue-raising capabilities and they are having to cut back on expenditures. This is something we have seen take place in Boston, Baltimore, Cleveland, and Buffalo, and now, of course, New York City.

The recession is to blame; but, also cities have suffered enormously by inflation. A recent study has shown that the purchasing power, the real purchasing power of the city, has declined by about 15 percent over the last 2 or 3 years, and as a result they are having to undergo the very tough decisions that all sectors of the economy now face.

I might point out that many of the toughest decisions are already made or in the process of being made, since about half of the jurisdictions are on a July and June fiscal year. So, the austerity budgets, replete with budget cuts, have been or are in the process of being voted.

If the forecasters are right, the economy will start its recovery, and I hope this should pull most units out of the worst of their present fiscal problems.

Mr. Gradison. I hope you understand the problem we have with the House in session.

Mr. Evans. If you care to go ahead now we can continue.

Please continue.

Mr. Petersen. What can we say of the present market situation for municipal bonds? The market behavior of municipalities shows heavy short- and long-term capital demands reflecting the return of bonds, which have been postponed in the tight money markets of 1974, and the accumulating need to replenish the depleted bond funds and to ease cash shortages.

Certainly the relatively heavy volume of State and local borrowing, which now is at an annual rate of about $26 billion long term and $32 billion short term for the first 5 months of this year, should not be mistaken for easy market accommodation. Interest rates are still high and where there are any doubts about the credit quality they are at historic highs.

Depending on the quality, municipal bonds at 20 years are now ranging between 6 and 8 percent. For revenue securities the yields are even higher.

In addition, would-be borrowers are postponing bonds at nearly double the record rate experienced last year and they are shortening the life of debt in an effort to squeeze in underneath interest rate ceilings.

The key feature, really interesting feature, of the first quarter of this year, and one evidently continuing today, is the unparalleled length and depth of the departure of large banks from the tax-exempt bond market.

The market through the first quarter of this year was almost entirely supported by households, that is mainly individual investors.

Within the banking sector large reporting banks ran down their ownership of tax exempts by over $2 billion. This was barely offset by country or small bank purchases.

This reduction in large bank purchases has taken place at a time when banks typically are substantial purchasers of municipals as they replace falling loan demand with securities and build liquidity.

As of the end of May, bank loans dropped by over $20 million. So have their outstanding certificates of deposits. What has been going up is their purchases of Federal Government securities. In other words, banks are pulling in their horns and are financing the Federal deficit instead of the State and local one.

There has been identified a secular decline in large bank demand for tax exempts. The decline, taking place over a number of years, is worrisome. Banks evidently have found more attractive ways to shelter income—leasing operations and foreign tax credits. Also they have substituted as much tax-exempt debt for Federal debt as they find prudent in terms of liquidity needs.

Contributing now to the lack of bank appetite, and I think a very real cloud over the recovery prospects for the tax-exempt market, is the existence of larger loan writeoffs due to the recession and real estate losses.

Furthermore, bank liabilities are growing much more slowly as the flow of deposits shifts to other intermediaries.

It has been a characteristic of the municipal bond market that when the banks are out, interest rates are up. If the banks have not been actively supporting municipals in a period of economic downturn, the worst we have experienced since the Great Depression, what will happen as recovery takes hold and businesses and consumers are back into the banks with greater credit demands? How will the continuing Federal deficit financing needs, which will probably run nearly $50 billion in the second half of the year, compound this pressure?

Other investors must continue to pick up the slack in the tax-exempt municipal bond market.

If the pattern of the first quarter continues, however, the only sector left to do the job is the individual investor. However, a resurgence of the stock market, from which many individuals fled to buy tax exempts, could drain off household demand. This projected continued reliance of tax exempts upon the household sector will be costly.

We find reported in the press today that "Big MAC" is coming with its first issue of $1 billion. We know they have to raise $3 billion before Labor Day.

The Commonwealth of Massachusetts will borrow nearly a half-billion dollars next Monday. These will be exciting and trying times in the retailing of municipal bonds.

I would like to discuss a little bit the background of Federal credit assistance to State and local governments and some of the positions which have been developed throughout the years because I think they may be used in examining current proposals.

State and local government issuers as a group have been very wary of Federal credit assistance. This wariness springs from several sources—a fear of undermining tax exemptions; a fear of becoming involved in redtape and delay; and a desire of these governments to maintain autonomy as to borrowing and capital outlay decisions.

These views are shared by those who underwrite and trade municipals, where the emphasis is on a free, private market—one consisting of many buyers and sellers—and the thought that such a free market should be the centerpiece of the State and local capital-raising mechanism and a bulwark to their autonomy. Certainly that was the view presented this morning by Secretary Simon.

Mr. EVANS. Pardon me for interrupting. There is a recorded vote in the House. We will have to suspend the hearings for about 10 minutes.

We shall continue at that point.

Mr. PETERSEN. Certainly, sir.

[Recess taken.]

Mr. ROSENTHAL. Please continue, Mr. Petersen.

Mr. PETERSEN. Thank you, Mr. Chairman.

What I was doing was making a recital of some of the concerns State and local governments have had as regards to Federal credit assistance.

Their views really have been cemented together in a protection of preservation of the existing tax-exempt market, which in almost any circumstances still provides State and local borrowers with the lowest cost of capital in the market.

This subcommittee has received testimony referring to the ratio of tax-exempt to taxable bond rates. You will note it is always a decimal, that the tax-exempt rate is lower than the taxable bond rate.

The concerns of State and local governments about the role of the Federal Government and Federal credit assistance in the municipal area were focused in 1969 when Congress almost steered on a course of partially taxing municipal bonds and in the subsequent 2 years when the administration and Congress began proliferating various agencies and programs to debt-financing certain State and local activities.

At that time there was a deep concern that the tax-exempt bond market would either be swallowed up by a massive federally sponsored bank or chopped to pieces by an array of separate lending programs.

Furthermore, State and local governments were worried that hard-dollar grants would be replaced by soft loans on guarantees—in other words, that Federal credit assistance would become a substitute for grants.

Thus, in the early 1970's, with the market disruptions as caused by tax reform still fresh in memory, and the developing threat of Federal credit programs close at hand, various interest groups—governmental issuers, the industry and academics—started to study the relationship between Federal credit assistance and the traditional tax-exempt bond market.

There were differences in detail, but a consensus began to emerge that such assistance should be consistent with criteria. The criteria roughly were as follows:

That Federal credit assistance should be purely voluntary.

Such assistance should be free from Federal interference and intervention in matters of State and local concern.

Such assistance should be simple, dependable and free of delay.

Such assistance should not be viewed as an alternative to Federal grant assistance where the latter is appropriate and necessary.

Following those criteria, the various groups began to focus on particular aid mechanisms and another consensus began to form on the proposition that a properly designed and administered taxable bond option could meet those criteria. This subcommittee received testimony yesterday from one of the leading proponents of the taxable bond option, President Frank Morris, of the Federal Reserve Bank of Boston.

Certainly, all the groups were agreed that it was preferable to the continuation of the proliferation of the Federal lending programs and many felt that the option possessed strong positive advantages in terms of lowering borrowing cost and of providing stability to the market.

The basic idea is to market bonds where the investor preferences are for longer term obligations, which is not necessarily the case in the municipal bond area, and thereby broaden the option available to State and local governments.

The taxable bond option would require a subsidy since the taxable rate would always be higher than the tax-exempt rate.

In April of 1973 the Treasury did introduce a taxable bond option as one of its tax reform proposals of that year.

Obviously the Treasury liked the idea to a certain extent because it did not entail expanding the Federal bureaucracy and it did promise some possible improvements in the market. It had certain advantages, as Treasury perceived them, in the area of tax equity, as well.

However, by 1973 attention had begun to shift away from the option and Federal credit assistance programs. The municipal bond market, while not without some pressures, performed well in comparison to the other market.

Furthermore, opposition to the option idea, primarily on the grounds that the Federal Government—either by intent or circumstances—would use an option as a snare to entrap State and local governments into a Federal handout that would be withdrawn at a later date. In the context of good markets and dedicated oppositions, the idea of the option drifted back on the shelf of possibilities.

I discuss the option because I think it is quite important when considering Federal assistance to think in terms both of the general assistance program and assistance program aimed at particular credits.

Most of the discussion recently has been about particular assistance types of programs, assisting a particular city or State.

In response to the fiscal problems of New York City and other municipal borrowers several bills have been proposed recently in Congress to provide a means by which States and localities can borrow, either to avoid default or to borrow at higher rates of interest.

These proposals can be divided into two groups:

One, creation of a Federal Government agency designed to purchase, refinance, and remarket municipal debt instruments.

Two, authorization of emergency loan guarantees to State and local governments, or some kind of insurance program.

I notice in this morning's Washington Post that such an insurance program for municipal bonds is being discussed in the administration. Secretary Simon testified to that situation this morning.

Noteworthy are the bills introduced by Senators Javits and Bentsen, and Congressmen Biaggi and Richmond. All four of the assistance measures have a slightly different approach to giving assistance to cities in fiscal distress. I review those proposals in my written statement.

All of the proposals drive a wedge between the market and the improvident city borrowers. Most contemplate direct assistance and all call for assessment of the borrower's financial conduct, as a condition for help.

There are several potential problems with direct assistance to cities, which I shall recite briefly.

First, any measure that extends the Federal guarantee to a hard-pressed borrower who might not otherwise borrow indirectly places pressure on those borrowers already in the market. In other words, to permit a rationed-out municipality back into the market means rates will have to go up as the market has to clear a larger supply of bonds.

The laws of supply and demand cannot be seen but, like the wind, they have to be felt. I can guarantee that they operate in the tax-exempt market as in any other market.

In view of the supply problems and the taxes foregone, a large supply of such securities would not seem desirable especially if one takes seriously the question of efficiency of the tax exemption. To the degree tax exemption does allow State and local government to enter the market on a preferred position, that preference, those interest cost savings are diminished by an overuse of them because there is just so much tax shelter that seeks bonds at any one time.

Second, a guarantee promotes the weakest credits to the head of the line and means that they can borrow at a lower rate than otherwise higher rated credits. It also places considerable economic pressure on those left at the end of the quality line to miss getting a reasonable offer in the conventional market so they can qualify for Federal assistance.

Here is something of an equity problem you have to contend with if you choose the Federal guarantee.

A Federal guarantee will elevate a municipal borrower to the premier position in the market and allow it to borrow at a lower rate of interest than any other borrower.

What does this infer in terms of the relative market standing of an issuer who is not quite bankrupt and can get a bid in the market but, because he is not guaranteed, still has to pay a much higher rate of interest in order to borrow?

Third, the ability of the Federal authorities to correct situations must be diluted by a recognition that the borrower would not be in for help unless he has deep problems. Weaning the troubled government, especially when the problem is not just mismanagement or just a mistake in judgment, would take extraordinary judgment and most likely deep involvement in the affairs of the recipient jurisdiction.

It is worthwhile to note that complaints about such involvement by bankers and the financial community would not preclude similar complaints were it to be replaced by the involvement of Federal bureaucrats or politicians.

I might add, in closing this review, that it was on these grounds that many concerned parties in State and local government and the financial markets rejected categorical type assistance and elected to accept a more general form of assistance in the market; namely, the taxable bond option.

However, even the most avid supporters of the option would agree that such general assistance would do nothing directly for the sick government other than to take some of the lumps out of its bed and, by opening some new windows, perhaps help avoid the contagion from spreading to others.

Nevertheless, when faced with the cessation of vital services, the general opposition to Federal intrusion into the market has not precluded support from time to time of particular forms of Federal credit assistance by State and local governments, especially in the area of housing and hospitals.

For example, when the administration lately sought to remove tax exemption from certain classes of federally assisted tax-exempt bonds, under a proposed OMB circular A-70, the affected interests let it be known that use of Federal guarantees and subsidies remained essential to keep vital State housing assistance programs moving.

I am afraid, as Secretary Simon pointed out, when you are discussing the means, even the mechanisms of giving assistance to this sector, you are essentially faced with a political question, a question of political philosophy in terms of degree of separation between the State and local and the Federal sectors.

How about other potential improvements in the municipal market? Given the limitations on demand for tax exempts one way to improve things is to reduce the supply of new debt. Of course, the market already is attempting to do this by requiring higher rates of return on municipals, especially those of lower quality. In other words, natural adjustment of supply of funds to the demand for them does force out certain borrowers who simply cannot pay the going rate. Evidence on this phenomenon is given by the large number of bond issue postponements in the market that I mentioned earlier.

This is running roughly double the rate this year as compared to last year and last year was the record, with nearly $2½ billion in postponements.

Another way of reducing the volume of tax-exempt debt is by legislative act to deny tax exemption for certain uses. The leading example of this having been done is that of the industrial revenue bond—tax exempts sold on behalf of private enterprise—back in the late sixties. Arbitrage bonds—tax exempts sold for the purpose of reinvesting the proceeds in higher yielding taxable bonds—is another use in point.

Interestingly, the prohibition of industrial development bonds back in 1969 was not complete. Several purposes were excepted from the prohibition, including issues sold on behalf of corporations for purposes of pollution control. Furthermore, conventional industrial development bonds were permitted to be sold if they were below $5 million in size and met certain other conditions. These exceptions have grown to be very important and in the opinion of many, the large volume of financing done for industries in the tax exempt market has had a depressing effect on the tax exempt market. The difficulties of assessing the impact has been compounded by the fact that the reported sales, nearly $2 billion last year, is undoubtedly less than what actually occurred.

After undertaking a thorough study of the area, the Municipal Finance Officers Association adopted a position calling for the elimination or at least a major sizing back of the pollution control bond and its replacement by a more efficient subsidy vehicle. I have attached copies of the analysis and the MFOA position to my testimony.

Other uses of tax exemption have been criticized from time to time, especially advanced refunding bonds, which lead to a multiplication of outstanding tax exempt debt for a particular project.

The restriction of the supply of tax exempt debt does help those borrowers and uses that remain, simply because the value of tax exemption is less diluted. In other words, with fewer bonds to compete for funds, they become dearer and the rates of interest go down accordingly.

Assistance plans, either specific or general, that increase the overall supply of tax-exempt bonds without in some way increasing the demand for them will lead to higher rates, relatively, in that market. It is by no means certain that recycling particularly weak credits to a stronger position will ease the market yields on those lower grade bonds that remain and it will surely add to the pressures in the high grade end of the market. Of course, the impact of assistance on investor confidence, in general, may be a leavening factor in terms of prices. But the net influence on the cost of capital in the face of overall higher levels of bond sales is conjectural, at best.

One other factor that should be mentioned, I believe, is the concern of investors over the adequacy of supply of information regarding governments and their fiscal condition. I might say that this concern is of recent vintage.

For years the municipal bond market underwrote and traded bonds primarily on the basis of the ratings given by the rating agencies.

As of late this has changed. There is now quite an effort going on in the market to obtain better information and to improve the quality of analysis of municipal securities.

The association for which I work is working very diligently in trying to prepare information standards specifically for the financial markets; and, this is a continuation of our concern about good accounting and good reporting procedures in State and local governments.

Perhaps one good outcome of the travail of present time will be more public awareness and investor awareness of the importance of good financial management and reporting in the State and local area.

Mr. Chairman, as I have mentioned, I have a written statement with attachments. I would request that that be put in the record.

Mr. Rosenthal. Without objection, the total statement will be inserted.

[Mr. Petersen's prepared statement follows:]

PREPARED STATEMENT OF JOHN PETERSEN, WASHINGTON DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION[1]

In this paper I will review the impact of economic conditions on the fiscal performance of the State and local sector from 1970 through the rapid recessionary turn of 1974 and 1975. The emphasis will be on the shift in financing requirements and sources and the growing difficulties of balancing their budgets that State and local governments are now experiencing.

Next, I will review the changing nature of capital outlay demands by the sector. These are of particular importance because of the traditional reliance placed upon long-term borrowing by State and local governments. I will focus on the changing composition of the types of funds used to support these expenditures.

Following that will be a brief consideration of municipal bond market performance over the past five years and of how the cost of capital has been influenced by inflation and by the relative availability of funds to the State and local tax-exempt market from key investor groups. Last, I will discuss what I believe are the salient issues surrounding possible forms of Federal credit assistance to the State and local governmental sector.

STATE AND LOCAL EXPENDITURES, RECEIPTS, AND BUDGET BALANCES SINCE 1970

From 1970 through 1972, State and local governments (excluding retirement funds) showed a rapid growth both in their expenditures and receipts. As Table 1 illustrates, receipts from their own sources, mainly tax revenues, showed a high effective elasticity with respect to GNP. Generally, governments benefited from both tax rate increase and prosperity. The rate of inflation in this period was moderate, primarily owing to the existence of price and wage controls. Temporarily, at least, the sector was a net financial gainer. The first three years of the decade as the economy emerged from the tight money period and mini-recession of 1970, might be characterized as one of accumulation for the sector and a replenishing of asset positions.

By 1973, however, State and local governments turned a fiscal corner. Prices became progressively unglued. Tax receipts did not keep up with the growth in current-dollar GNP, although expenditures continued to accelerate. After the budget created by Revenue Sharing in 1972, the growth in Federal aids likewise tapered off and the sector slid into a deficit position.

The reasons for the reversal from surplus in the State and local balance to a deficit are grounded in many factors. But an important one was the inability of the revenue base to advance with inflation. Actually, many State and local governments elected to constrict their tax bases in 1972 and 1973 and made little in the way of offsetting changes to improve their revenue raising capacity.[2] When real output and income flagged in mid-1974, the bottom dropped out of revenues. As of the last quarter of 1974 and the first quarter of 1975, the deficit position of State and local government had gone to $15 billion.

TABLE 1.—STATE AND LOCAL NATIONAL INCOME ACCOUNTS SELECTED ITEMS FOR 1970-74 (CALENDAR YEARS)

	Amount (billions of dollars)					Change from prior year (percentage)			
	1970	1971	1972	1973	1974	1971	1972	1973	1974
Total receipts	135.0	152.2	177.2	193.5	207.7	12.7	16.5	9.2	7.3
Own receipts	102.3	114.0	129.2	141.3	151.1	11.1	13.3	9.4	6.9
Federal grants	24.5	29.0	37.4	40.5	43.7	18.4	29.0	8.3	7.9
Total expenditures	133.2	148.8	164.9	184.4	206.0	11.2	10.8	11.8	11.7
General government net surplus [1]	−4.5	−2.9	4.5	−.3	−10.1				
Items:									
GNP	977.0	1,055.0	1,158.0	1,295.0	1,395.0	8.0	9.8	11.8	7.8
GNP price index [2]	135.0	141.0	146.0	154.0	170.0	4.5	3.4	5.6	10.2
State and local price index [2]	165.0	174.0	184.0	195.0	215.0	5.8	5.5	6.2	10.2

[1] After allowance for retirement credit to household and does not equal differences in NIA defined expenditures and receipts as shown above. Items shown do not balance because of various omissions.
[2] 100=1958.

Source: Federal Reserve "Flow of Funds, Economic Report of the President, 1975."

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[1] The views contained in this paper are solely my own as an individual and do not necessarily represent those of the Municipal Finance Officers Association.

[2] See "State and Local Fiscal Position" *Survey of Current Business* (November 1974), pp. 5–7. Besides reduction tax bases and rates, it appears that at high rates of inflation tax bases do not grow as rapidly as the prices governments must pay for goods and services. Also many items are taxed *ad rem* and therefore grow only with real output.

The deepening deficit position for the sector now means short-term borrowing or asset rundowns must continue to sustain outlays—or expenditures themselves must be pruned back. Another alternative, of course, is to raise tax rates and expand the revenue raising capability. This is difficult in the face of recession and works in opposition to the counter-cyclical policies of the Federal Government.

At the present time, we are seeing all these alternatives being employed. Since there is no central reporting point for quickly assessing State and local positions in any detail, one must rely on ad hoc surveys and sifting through newspaper items; but the information gleaned is insightful. For example, a recent survey by the Joint Economic Committee has reported that States and localities are about splitting even between raising taxes and reducing expenditures—enough to reduce their current budget deficits by about $8 billion.[3] Probably another billion will be saved in capital outlay cutbacks.

At the same time, reported short-term debt sales by State and local governments for the first quarter of 1975 were nearly $8 billion—even though New York City was an uncharacteristically small net borrower in the markets during the first three months. Most localities can't borrow to balance operating budgets outside of one year.

The burdens of retrenchment are not evenly distributed—the bulk of cutbacks and tax increases are coming in those states and cities where unemployment rates are highest. Many areas, while thinner, still have reserves.

It might be noted that the toughest decisions already have been made at the State and local level. At least half of the jurisdictions are on the July–June fiscal year and the austerity budgets, complete with tax increases and budget cuts, have been or are in the process of being voted. If the forecasters are right, the economy will start its recovery and, I hope, pull most units out of the worst of their fiscal despond.

STATE AND LOCAL CAPITAL OUTLAYS—RECENT TRENDS

An assessment of the performance of the municipal bond market should commence with some observations on the demand for funds represented by capital outlays. The effect of the spiraling prices on State and local capital outlays has been quite substantial since 1970. To illustrate this, I have taken in Table 2 reported expenditures of State and local governments on both structures and capital outlays (structures plus durable goods purchases) and deflated them by the Commerce construction price index. When deflated, the big dollar jump in 1974 was evidently wiped out by a phenomenal increase in construction prices. As may be seen, the deflated figures show a steady decay of real capital outlays. When these, in turn, are deflated by population to derive per capita figures, we see an even more pronounced decline. While capital outlays in current-dollar terms have grown, the "bricks and mortar" or real purchases have declined both absolutely and in per capita terms. In fact, real per capita capital outlays have declined each year since 1968!

Several explanations are to be offered. One is that the accelerator effects of population growth and new regional development (the explosive growth of suburbia in the 1960's) have dwindled and the most vital social infrastructure needed has been largely built. Also, the budgetary pressures engendered by the rapid spiral of expenditures for labor-intensive, current operations (new services and more expensive labor) have limited the financial abilities of State and local governments to meet all but urgent capital outlay needs (or those that are self-supporting). Added factors are the high costs of borrowing and the slowdown in Federal grants for construction.

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[3] Joint Economic Committee, *The Current Fiscal Position of State and Local Governments* (May 6, 1975).

TABLE 2.—CAPITAL OUTLAYS BY STATE AND LOCAL GOVERNMENTS 1970-74

[In billions of dollars]

	1970	1971	1972	1973	1974
Structures	25.1	26.3	26.5	28.8	34.0
Durables	5.6	6.0	6.3	6.6	7.0
Total capital expenditures	30.7	32.3	32.8	35.4	41.0
Deflated (1970=100)	30.7	30.6	29.4	29.1	28.4
Real per capita	150.0	148.0	142.0	138.0	134.0
Items:					
Price index (1970=100)	100.0	105.4	111.4	121.8	144.3
Rates of increase in prices		5.4	5.6	9.3	18.5

Source: National income accounts.

How long will the decay in real capital investment by State and local governments continue? That depends on how much it is on outgrowth of a real reduction in capital needs versus a result of fairly temporary fiscal stringency. In any event, the nature of capital outlays appears to be in a transition from the expansive needs of a growth society to the intensive, qualitative improvements of a mature and public-good oriented one.

CAPITAL OUTLAY FINANCING PATTERNS

Typically, most State and local government long-term borrowing is undertaken for purposes of capital outlays of one form or another. Short-term debt is harder to characterize, since it is used extensively to anticipate revenues. But that part which is reported as note sales and carried over from year-to-year as a net increase probably serves as a reasonable proxy for short-term borrowing for capital purposes (bond anticipation notes).

The path of State and local borrowing during the recent inflationary times has been largely in consonance with capital expenditures: there has been some growth in nominal terms but a decline in real terms. Of course, capital outlays can be financed in other ways than by borrowing. Thus, to appreciate the role of debt in capital expenditures it is important to see what have been the other sources of financial capital for financing construction and durable expenditures.

Table 3 sets out some very rough comparisons between recent capital expenditures and the probable sources of their financing. These comparisons are rough because the national accounting data series (and extensive data gaps) do not conveniently support this type of analysis.[4] Still, certain broader trends are evident.

The important item to note first is the practically level trend in total debt financing figures (gross bond sales and net charge in short-term debt) since the record of 1971. After the spurt in 1971 growth in sales has moderated to a crawl. Federal grants (including an estimated portion of revenue sharing) for capital items has provided some lift to expenditures. But, it has been the other sources that recently have picked up the slack. The other sources available are current revenues or a running down of asset positions. During the salad days of 1971 and 1972, these sources evidently contributed little on net balance for capital outlays. This meant that bond funds were built up in the aggregate. Recently, however, the sector has plunged rapidly into a deficit position. The deteriorating savings position of general governments is shown as an item in Table 3. This means, essentially, that expenditures if they are to continue in the face of pinched revenues must be debt-financed or government asset positions must be run down to provide funds.

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[4] The short-term borrowing figures, in particular, are universally asknowledged to be understated.

Judging by what must be the relatively heavy drain of capital outlays on current revenues and liquid assets in 1973 and 1974, the remaining margin for sustaining them by these sources is limited in the future. Thus, sustained inflation—coupled lately with a sharp recession—has had an ultimate influence of depressing long-term borrowing as a source of construction funds to the sector and of eroding other sources (principally of assets in bond funds) available to capital financing. Furthermore, borrowing may have to be resorted to keep current operations afloat as well as to finance capital expenditures. The likely outcome in the near term appears to be for more short-term borrowing to buoy up the current budget and long-term borrowing to replenish bond funds and to support existing or slightly increased levels of capital outlays.

TABLE 3.—STATE AND LOCAL CAPITAL OUTLAY FINANCING

[In billions of dollars]

	1970	1971	1972	1973	1974
1. Capital outlay	30.7	32.3	32.8	35.4	41.0
Gross bond sales	17.6	24.2	22.5	20.8	20.2
Change in short-term debt	2.3	2.5	−.7	−.2	2.9
Total	19.9	26.7	21.8	20.6	23.1
Federal capital grants	6.6	7.0	7.7	8.0	8.8
Revenue sharing [1]			1.9	2.1	2.2
Total	6.6	7.0	9.6	10.1	11.0
2. Total debt and grants	26.5	33.7	31.4	30.7	34.1
Apparent net other sources (1.−2.) [2]	4.2	−1.4	1.4	4.7	6.9
Item general Government surplus [3]	−4.5	−2.9	4.5	−.3	−10.1

[1] Estimated as used for capital outlays: (35 percent of total). See "General Revenue Sharing: Reported Uses 1973-74" (February 1975) p. 35.

[2] Other sources represent estimated net claim on (a.) current revenues after allowance for debt repayment and (b.) net claim on financial assets.

[3] NIA basis, adjusted for retirement credit to households.

MUNICIPAL BOND MARKET PERFORMANCE

By and large, the sector as a borrower of capital funds did well after the initial round of tight money in 1969 and early 1970. In 1971 State and local borrowers did an enormous amount of bond financing in a relatively accommodative capital market. As may be seen on Table 4 long-term interest rates began to slide and during the mild inflationary pressures in 1972 and early 1973 crept downward. The ratio of municipal to corporate rates also improved, which is a good indication of relative ease in the municipal market. The fact is that State and local governments, having shot their bolt in 1971 and coasting on rapidly growing own revenues and Federal grants, were simply not that dependent on new borrowings.

The relative prosperity of the governments also led to relatively slight discounts for risk among the grades. Of great importance to the market—and the rate spread—was the large role played by Fire and Casualty Companies. In 1972 and 1973 they accounted for about a third of the net purchases of tax-exempts—an uncharacteristically heavy supply of funds from that source. Evidently, this permitted the support of both banks and individuals to be reduced without any depressing price effects. However, by 1974, Fire and Casualty companies began to reduce their net takings and the individual sector had to be enlisted rapidly back into the market.

TABLE 4.—STATE AND LOCAL GOVERNMENT BOND RATES AND NET BORROWING BY TYPE AND BY PURCHASER 1970–74

[Rates in percent; dollars in billions]

	1970	1971	1972	1973	1974
Municipal bond rate (all grades) [1]	6.42	5.62	5.30	5.22	6.20
Rate spread (Baa-Aaa)	.63	.67	.54	.50	.72
Ratio to corporate bond rates	.75	.71	.69	.67	.70
State and local net borrowing	11.2	17.6	14.4	13.7	17.0
Long term	8.9	15.0	14.5	12.2	12.4
Short term	2.3	2.5	−.7	−.2	2.9
Pollution control	0	.1	.5	1.8	1.6
Net purchase (sector)	−11.2	17.6	14.4	13.7	17.0
Fire and casualty insurance companies	1.5	3.9	4.8	3.9	1.1
Commercial banks	10.7	12.6	7.2	5.7	4.2
Other (primarily household)	−1.0	1.1	2.4	4.1	11.7

[1] Moody's composite series for all grades.

Source: Federal Reserve Board "Flow of Funds" (various numbers).

Heavy reliance on the household sector has invariably meant a closing of the relative ratio between taxable and tax-exempt yields and this occurred throughout 1974. Also, the retreat of Fire and Casualty companies in the long end of the market probably contributed to a lack of support to lower-grade, longer-term issues. Furthermore, the bulge of pollution control bonds (a borrowing figure that is known to be underestimated) and the decay of several major municipal borrowers' financial positions further aggravated the spread between prime (Aaa) and lower-grade (Baa) bonds. By the end of the year, a gulf of about one full percentage point separated the two averages. Reacting to rampaging rates, issuers began to stay out of the market or reject bids that they could not afford to accept. In 1974, a record \$2½ billion in municipal borrowings were either scrapped or postponed for a later date.

Bank demand has always been a fundamental feature of the tax-exempt market and the deterioration of their support in 1974 was due to both a reduced need for tax shelter and the pressures for short-term financing by other customers, much of it induced by the advanced ravages of inflation on corporate finance.

THE PRESENT MARKET SITUATION AND FUTURE CONCERNS

Market behavior of municipalities shows heavy short and long capital demands, reflecting both returns of bonds postponed in the tight market of 1974 and an accumulating need to replenish depleted bond funds and to ease burdens from steadily pinched reserves and revenues. Certainly, the relatively heavy volume of State and local borrowing (an annual rate of \$26 billion long-term and \$32 billion for short-term) for the first five months of this year should not be mistaken for easy market accommodation. Interest rates are still high for all tax-exempts and—where there are doubts about credit quality—are at historic highs for some. In addition, would-be borrowers are postponing bonds—at nearly double the record rate experienced last year—and are shortening the life of debt in an effort to make it under interest rate ceilings.

The key feature of the first quarter of this year and one which is evidently continuing through today is the unparallel length and depth of the departure of large banks from the tax-exempt bond market.

Table 5 illustrates the shift in sources of funds into the tax-exempt market. The table shows that at annual rates, the market through the first quarter of this year was almost entirely supported by households (mostly individual investors).

TABLE 5.—*State and local government borrowing by type and by purchaser, 1st quarter 1975*

[Rates in percent; dollars in billions]

Municipal bond rate (all grades)	6.66
Rate spread (Baa–Aaa)	1.03
Ratio to corporate bond rates	.71
State and local net borrowing	$16.3
Net Purchase (sector)	16.3
Fire and casualty insurance companies	.9
Commercial banks	.1
Households	15.6
Others	—.3

Source: Federal Reserve Board *Flow of Funds* Quarterly adjusted annual rates.

Within the banking sector, large reporting banks ran down their ownership of tax-exempts by over $2 billion which was barely offset by country bank purchases.

This reduction in bank purchases has taken place at a time when banks typically are substantial purchasers of municipals as they replace falling loan demand with securities and build liquidity. As of the end of May, loans at large banks had dropped by over $20 billion, but so have their large certificates of deposits, which often fuel municipal note purchases. What has been going up are their purchase of Federal government securities.

In other words, banks were pulling in their horns and financing the Federal deficit instead of the State and local one.

The secular decline in large bank demand for tax-exempts is worrisome: They have more attractive ways to shelter income—leasing operations, foreign tax credits—and have substituted as much tax-exempt debt for Federal debt as they find prudent in terms of liquidity needs. Contributing to a current lack of appetite—and a real cloud on the recovery prospects for tax-exempts—is the existence of larger loan write-offs due to the recession and real estate losses. Furthermore, bank liabilities are growing much more slowly as the flow of deposits shifts to other intermediaries.

Now if banks have not been actively supporting municipals in an economic downturn, what will happen as recovery takes hold and business and consumer demands pick up? How will the continuing Federal deficit financing needs compound the pressure? Other investors must continue to pick up the slack in the tax-exempt market. If the pattern of the first quarter continues, however, the only sector left to do the job is the individual investor. But, a resurgence of the stock market—from which many individuals fled to buy tax-exempts—could drain off household demand. The projected continued reliance of tax-exempts upon the household sector will be costly.

SOME BACKGROUND ON FEDERAL CREDIT ASSISTANCE TO STATE AND LOCAL GOVERNMENTS

This session of Congress has brought forward many proposals to broaden and stabilize the municipal bond market or to assist hard pressed local governments. These are two distinct, if interrelated, purposes and the differences should be appreciated in the discussion of such proposals.

Before I discuss the various mechanisms, I think it would be helpful to recount some of the concerns that State and local governments, the financial community, and others have had as regards to Federal Credit programs.

State and local issuers as a group traditionally have been wary of Federal Credit assistance. This springs from several sources: a fear of undermining tax-exemption, becoming involved in red tape and delays, and their desire to maintain autonomy as to borrowing and capital outlay decisions. These views are shared by those who underwrite and trade municipals, with the emphasis that a free, private market—one consisting of many buyers and sellers—should be the centerpiece of the State and local capital raising mechanism and a bulwark to their autonomy. These views are cemented together, therefore, in preservation of the existing tax-exempt market, which in almost any circumstance still provides State and local borrowers with the lowest cost of capital in the market.

These concerns were focused in 1969 when Congress almost steered on a course of partially taxing municipal bonds and in the subsequent two years when the

Administration and Congress began proliferating various agencies and programs to debt finance certain State and local activities. At that time, there was a deep concern that the tax-exempt bond market either would be swallowed up by a massive Federally sponsored bank or chopped to pieces by an array of separate lending programs. Furthermore, State and local governments were worried that hard dollar grants would be replaced by soft loans on guarantees . . . in other words, that Federal Credit assistance would become a substitute for grants.

Thus, in the early 70's, with the market disruptions of tax reform still fresh in memory and the developing threat of Federal Credit programs close at hand, various interest groups—issuers, industry, and academic—started to study the relationship between Federal credit assistance and its relationship to the traditional tax-exempt bond market. There were differences in detail, but a consensus began to emerge that such assistance should be consistent with the following criteria adopted by the National Governors' Conference:

"1. Use of any federal credit assistance programs by State and local governments should be entirely voluntary.

"2. Such assistance should be free of federal interference and intervention in matters of State and local concern.

"3. Such assistance should be simple, dependable, and free of delay.

"4. Such assistance should not be viewed as an alternative to federal grant assistance where the latter is appropriate and necessary."

Similar criteria have been set forth by the National League of Cities, the National Association of Counties, the Municipal Finance Officers Association, and the Securities Industry Association.[5]

Following those criteria, the various groups began to focus on particular aid mechanisms and another consensus began to form on the proposition that a properly designed and administered taxable bond option could meet those criteria. Certainly all the groups were agreed that it was at least preferable to a continuation of the proliferation of Federal lending programs and many felt the option possessed strong positive advantages in terms of lowering borrowing cost and of providing stability to the market. A great deal of research went into the option and its operation and discussion came to center upon mechanics rather than its overall desirability.[6] In April 1973, the Treasury did introduce a taxable bond option as one of its tax reform proposals of that year. However, by that time attention had begun to shift away from the option and Federal Credit assistance programs. The municipal bond market, while not without pressures, performed well in comparison to the taxable market. Furthermore, opposition arose to the option idea, primarily on the grounds that the Federal government—either by intent or circumstance—would use an option as a snare to entrap State and local governments into a Federal handout that would be withdrawn at a later date. In the context of good markets and dedicated oppositions, the idea of the option drifted back on the shelf of possibilities.

CREDIT ASSISTANCE PROPOSAL CURRENTLY UNDER DISCUSSION

In response to the fiscal problems of New York City and other municipal borrowers, several bills have been proposed recently in Congress to provide a means by which States and localities can borrow, either to avoid default or at lower rates. These proposals can be divided into two groups: (1) creation of a federal government agency designed to purchase, refinance and remarket municipal debt instruments, and (2) authorization of emergency loan guarantees to State and local governments. Noteworthy are the bills introduced by Senators Javits (R-NY) and Bentsen (D-Tex.) and Congressmen Biaggi (D-NY) and Richmond (D-NY). All four of the assistance measures have a slightly different approach to giving assistance to cities in fiscal distress.

Senator Bentsen's bill, "The Emergency Municipal Assistance Act of 1975" (S. 1862) amends the Federal Finance Bank Act of 1973 by allowing the Federal Financing Bank (FFB) to purchase short-term debt obligations of local governments. The proposal's intent is to prevent any major municipality from defaulting on its debt obligation and/or being forced to initiate bankruptcy proceedings; however, there are important restrictions that prevent financing of long-term municipal capital expenditures by the FFB. The FFB could purchase up to $3

[5] See statements of the above cited groups in *Federal Financing Authority*, hearings before the Senate Committee on Banking, Housing and Urban Affairs (May 15–17, 1972).

[6] A thorough discussion is found in Committee on Ways and Means, U.S. House of Representatives, *An Alternative to the Tax-Exempt Bond: Panel No. 8* (February 23, 1973).

billion of municipal debt in the aggregate; the securities must have a term life of two years or less. In addition, cities must prove their inability to obtain financing from alternate sources to the Secretary of Housing and Urban Development as well as submit to HUD a "comprehensive plan of fiscal and budgetary expenditures and controls" which will permit the retirement of the debt within the stipulated time period. Also, the monies received can be used only to pay off current liabilities.

The Javits proposal (S. 1833) would establish a Loan Guarantee Policy Board within the Department of the Treasury, with the Federal Reserve Board acting as fiscal agent of the guarantee program. The municipality requesting the guarantee would have to prove that it has exhausted all other sources of financing, and provide data showing that repayment of the loan is assured (evidence of balanced municipal budget and a long-range plan assuring future balanced budgets are considered the bare minimum under the conditions of the bill). Ceilings for loan guarantees are $500 million per municipality per year, except in extreme cases where the Secretary of the Treasury may submit to Congess a report detailing the necessity for a guarantee of a larger amount, subject to the approval of the full Congress. The maximum amount guaranteed by the Secretary of the Treasury can never exceed $5 billion at any given time. The proposal of Congressman Richmond (H.R. 7517) is similar to that of Senator Javits and would set up a Municipal Bond Guarantee Fund inside of Treasury. Evidently any borrower would be able to get the guarantee for a charge of between ¼ and 1 percent of the principal amount of the borrowing, were it found to be financially responsible.

Congressman Biaggi has introduced a bill that would establish the Federal Municipal Credit Corporation (H.R. 7747). Organized along the lines of FNMA, the Corporation would have the power to purchase, refinance, and remarket general obligation bonds of States and localities in the primary markets, with the option to resell the bonds to either the Secretary of the Treasury or to the general public. Also, the Corporation would be empowered to buy municipal bonds on the secondary market if the investment banker (or bankers) underwriting the issue can prove that the bonds cannot be marketed to private investors. The Corporation would be able to issue its own securities, tax-exempt stocks and debentures and short-term obligations. It would have access to a $2 billion line of credit with the Treasury and its securities would be viewed, in my opinion, on that basis—as a Federal government moral obligation.

All of the above proposals drive a wedge of Federal creditworthiness between the market and the improvident city borrower. Most contemplate direct assistance and all call for direct Federal assessment of the borrowers financial conduct. (The Biaggi bill is, on the other hand, geared to stabilizing the secondary market since it does not make direct loans or guarantees of individual issues; it can, however, refinance directly by exchanges with an issuer.)

There are several potential problems with direct assistance, which I will now briefly recite. First, any measure that extends a Federal guarantee to a hard pressed borrower who might not otherwise borrow indirectly places pressure on those borrowers already in the market. In other words, to permit a rationed-out municipal borrower back in the market means that rates will go up as it has to clear an enlarged supply of bonds. In view of the supply problems in the tax-exempt bond market, an enlarged supply of such securities would not seem desirable, especially if one takes seriously the question of the efficiency of tax-exemption.

Second, a guarantee promotes the weakest credits to the head of the line and means that they can borrow at a lower rate than an otherwise higher-rated credit. It also places considerable economic pressure on those left at the end of the quality line to "just miss" getting a reasonable offer in the conventional tax-exempt market so that they can qualify for Federal assistance.

Third, the ability of the Federal authorities to enforce fiscal discipline must be diluted by a recognition that the borrower would not be in for help unless he had deep problems. Weening the troubled government—especially when the problem isn't just mismanagement or a mistake in judgment—would take extraordinary judgment and, most likely, deep involvement in the affairs in the recipient jurisdiction. It is worthwhile to note that complaints about such involvement by bankers and the financial community would not preclude similar complaints were it to be replaced by the involvement of Federal bureaucrats or politicians.

I might add, in closing this review, that it was on these grounds that many concerned parties in State and local government and the markets rejected categorical type assistance and elected to accept a more general form of assistance in the market with the taxable bond option. Even the most avid supporters would agree that such general assistance would do nothing directly for the sick government other than to take some of the lumps out of its bed and, by opening some new windows, perhaps help avoid the contagion from spreading to others.

Nevertheless, when faced with the cessation of vital service, the general opposition to Federal intrusion into the market has not precluded support from time to time of particular forms of Federal credit assistance, especially in the area of housing and hospitals. For example, when the administration lately sought to remove tax-exemption from certain classes of Federally assisted tax-exempt bonds (under a proposed OMB circular, A-70) the affected interests let it be known, forcefully and successfully, that use of Federal guarantees and subsidies remained essential to keep vital State housing assistance programs moving.

OTHER POTENTIAL IMPROVEMENTS IN THE MUNICIPAL MARKET

Given the limitations on demand for tax-exempts, one way to improve things is to reduce the supply of new debt. Of course, the market is already attempting to do this by requiring higher rates of return on municipals, especially those of lower quality. In other words, the natural adjustment of supply of funds to the demand for them does force out certain borrowers who simply cannot pay the going rate. Evidence on this phenomenon is given by the large number of bond issue postponements in the market that I mentioned earlier.

Another way of reducing the volume of tax-exempt debt is by legislative act to deny tax-exemption for certain uses. The leading example of this having been done is that of the industrial revenue bond—tax-exempts sold on behalf of private enterprise—back in the late 60's. Arbitrage bonds—tax-exempts sold for the purposes of reinvesting the proceeds in higher-yielding taxable bonds—is another use in point.[7]

Interestingly, the prohibition of industrial development bonds back in 1969 was not complete. Several purposes were excepted from the prohibition, including issues sold on behalf of corporations for purposes of pollution control. Furthermore, conventional industrial development bonds were permitted to be sold if they were below $5 million in size and met certain conditions. These exceptions have grown to be very important and in the opinion of many of the large volume of financing done for industries in the tax-exempt market have a depressing effect on the tax-exempt market. The difficulties of assessing the impact has been compounded by the fact that the reported sales (nearly $2 billion last year) is undoubtedly less than what actually occurred.

After undertaking a thorough study of the area, the Municipal Finance Officers Association adopted a position calling for the elimination or at least a major sizing back of the pollution control bond and its replacement by a more efficient subsidy vehicle. I have attached copies of the Analysis and the MFOA position to my testimony.

Other uses of tax-exemption have been criticized from time to time, especially advanced refunding bonds, which lead to a multiplication of outstanding tax-exempt debt for a particular project.[8]

The restriction of the supply of tax-exempt debt does help those borrowers and uses that remain, simply because the value of tax-exemption is less diluted. In other words, with fewer bonds to compete for funds, they become dearer and the rates of interest go down accordingly.

Assistance plans, either specific or general, that increase the overall supply of tax-exempt bonds without in some way increasing the demand for them will lead to higher rates, relatively, in the market. It is by no means certain that recycling particularly weak credits to a stronger position will ease the market yields on those lower grade bonds that remain and it will surely add to the pressures in the high-grade end of the market. Of course, the impact of assistance on investor confidence in general may be a leavening factor. But the net influence on the cost of capital in the face of overall higher levels of supplies is conjectual, at best.

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[7] The collage of abstruse rules and regulations that grew out of these legislative prohibitions is frequently cited as evidence as why the Federal government should be kept out of any further involvement in the market.

[8] Lennox Moak, testimony before the Joint Economic Committee (June 20 ,1975).

The Tax-Exempt Pollution Control Bond

By John E. Petersen, Director, Municipal Finance Officers Association

This *Analysis* describes and analyzes the tax-exempt pollution control bond. These debt instruments represent a special class of industrial development bond that was specifically exempted from the tight restrictions that Congress in 1968 and 1969 placed upon most such tax-exempt borrowing done on behalf of private firms. The MFOA in the late '60s adopted a position in opposition to the continued use of tax-exempt industrial development bonds and supported in concept the restrictions which were placed upon the use.

The explosive growth of the pollution control bond has reopened the concern of many finance officers about the real and potential problems involved in such financing vehicles. Congress and many bond market professionals have spoken of the need to review the pollution control exception to the industrial development bond prohibitions and to gauge its overall impacts and efficiency as an aid to cleaning up the environment.

Reflecting these concerns and faced with the need to develop policy relating to these developments, the Committee on Governmental Debt Administration asked that a study of the pollution control issue be undertaken, tracing its development, market impacts, costs and benefits, and possible policy options. Members and other interested parties are invited to comment on the following study and to express what they believe should be MFOA's policy on this issue.

SUMMARY OF FINDINGS

The use of tax-exempt bonds issued on behalf of private corporations to finance pollution control expenditures has greatly increased over the past three years. The present levels of $2 billion in annual reported sales of these obligations which are typically large and very long-term bonds, have generated both philosophical and practical problems for the municipal bond market. This *Analysis* assesses the past and future performance of these securities, their impact on the bond markets, and the overall cost and benefits of this use of tax-exemption.

The findings, developed in detail below, can be summarized as follows:

—pollution control issues are likely to grow through the decade to $5 billion or more in annual sales (and could exceed that amount by another billion or so in unreported sales);

—as the volume of pollution control issues increases relative to other tax-exempts, the interest rate difference between them and comparable taxable securities decreases, and the absolute interest cost savings for issuers declines as taxable and tax-exempt rates come closer together;

—as the volume of pollution bonds grows, their added volume and higher yields drive up rates on all tax-exempt bonds, anywhere from 5 to 20 basis points (at a 20-year maturity) per billion of annual pollution bond financings, depending on market conditions;

—pollution control bonds are most directly competitive with other long maturity, term-structure and lower quality tax-exempt bonds and, therefore, they force up rates on these bonds to an even greater extent—an estimated 25 basis points or more under tight credit conditions;

—the use of tax-exempt pollution bonds includes a hidden but costly tax subsidy in addition to increasing the costs for other municipal borrowers. The annual subsidy cost of the $2 billion of bonds sold in 1973 totalled about $66 million, the bulk of it representing U.S. Treasury tax losses. By 1980, projections show the annual subsidy cost could range from $800 million to $1½ billion, with State and local taxpayers absorbing about one-quarter of the total in increased debt-service costs and foregone taxes;

—the subsidy is inefficient because 30 percent or more of the value of tax-exemption is lost to investors rather than being realized in reduced borrowing costs for pollution-control improvements; and

—a variety of alternative subsidy mechanisms are available involving special tax treatments and forms of loan subsidies. The costs and benefits of these should be thoroughly studied and compared with those now involved in tax-exempt financing.

PROLOGUE TO THE POLLUTION CONTROL BOND

The pollution control bond is the product of two converging trends: (1) the growth and transfiguration of the industrial development bond; and (2) public concern and legislation to abate or eradicate pollution.

The use of public tax-exempt credit to finance private firms has its modern origins in the industrial revenue bond. Beginning in the 1930's in the South, industrial revenue bonds were issued by State and local governments to finance the plant and equipment expenditures of new or expanding firms and, thereby, to bolster their own economies. The governmental units would borrow funds, build the plant, then sell or lease it to the private firm, which would make regular payments sufficient to meet the debt-service on the bonds. The principal attraction to the firm was the fact that it could enjoy lower borrowing costs because interest income on the municipal bonds was tax-exempt.

In the early years, industrial development bonds were limited mainly to small borrowers in the South and hence received little attention. Through the 1960's however, their use rose dramatically, culminating in $1.6 billion in new issues by 1968. By that year these issues had come to represent 10 percent of all long-term tax-exempt bond sales. Reacting to intense reaction from a variety of sources, first Treasury and then the Congress took steps to halt what was widely acknowledged as an abuse of tax-exemption and a threat to the conventional municipal bond market.

As an amendment to the Revenue Act of 1968, Congress halted tax-exemption of all industrial development bonds in excess of $1 million sold after January 1, 1969. Later in 1968, Congress loosened the size limit and established the basic restrictions for future industrial-aid issues. Since January 1969, the interest income on industrial-aid bonds has been exempt from Federal income taxes only if the issue is not above $1 million in size, *or* the total of the issue plus capital expenditures of the leasing firm within the issuing jurisdiction does not exceed $5 million for 3 years before or after the issue.[1]

The exclusion of industrial development bonds from tax-exemption was accomplished by the addition of Section 103(c)(1) to the Internal Revenue Code. However, an exception to that exclusion was made in Section 103(c)(4) of the code. Certain facilities financed by industrial revenue bonds on behalf of private firms were exempted from the size-of-issue restrictions, namely, residential property; sports facilities; convention facilities; transportation facilities; sewerage, water solid waste and energy facilities; industrial parks and—most notably—air and water polluton control facilities.

The basic law ultimately gave birth to the usual extensive regulations from Treasury; but, for the time being, industrial development bonds were quiescent. Sales of development bonds fell from a peak of $1.6 billion in 1968 to only $50 million in 1969. The disuse would prove only temporary.

However, a second trend was at hand, one which would make the pollution control exception of particular interest. This was, of course, the flood of Federal legislation aimed at cleaning up the environment. In 1969—the year Congress further curbed the use of tax-exemption with passage of the arbitrage bond regulations—the National Environmental Protection Act was passed. Soon after, Congress created the Environmental Protection Agency (EPA) whose function was to establish and enforce standards of environmental protection.

Two Federal Acts provided substance (and economic impact) to the EPA's mission: The Clean Air Act of 1970 and The Water Pollution Control Act of 1972. The Clean Air and Water Acts together set forth requirements that certain standards be promulgated and that these be enforced—primarily by the States—to prevent or abate pollution by toxic and hazardous substances in the air and water. The economic effect of these laws was to require large scale investments by industry to meet the standards. Under the Water Pollution Control Act industrial polluters were required to adopt the best practical control technology currently available by 1977 and the best available by 1983. The practical consequence of this language has been to require the adoption of certain approved control methods. Federal Air Quality Standards are somewhat more flexible, but in many respects they also virtually mandate adoption of pollution control technology and, consequently, investment expenditures. The Federal laws have engendered and have been supplemented by pollution requirements in the various States. These also have led to pollution control investments, frequently specifying the design criteria for new or replacement facilities.

The cost of the national clean-up for industry (that pollution related to site or stationary point emissions) as thus far written into law has been estimated to require from $5 to $15 billion a year in investments. Such investments are likely

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[1] Public Law 90-364, Sec. 107, 90th Cong. (June 28, 1968) as amended (October 24, 1968).

to reach a peak by the late 1970's and gradually decline through the 1980's. Of course, inflation and improved standards may lift these estimates, whereas relaxation or postponements in reaction to the energy shortage or financial difficulties may lower them. Recent reports, however, show expenditures to be roughly on target for the first few years. In 1974, industry spent an estimated $6½ billion on new plant and equipment designated for pollution abatement.[2]

The first pollution bond as such was brought out in 1971 to provide $5 million for a United States Steel installation in Pennsylvania. Since then more than $6 billion in sales have been reported and several hundred million dollars are estimated to have been spent but have *not* been reported, as will be discussed later.

HOW A POLLUTION BOND WORKS

To be tax-exempt, pollution control financing must be done through a State or local government entity empowered to enter into agreements and sell debt for such purposes. Typically, through special legislative act or constitutional amendment, special authority for this purpose is created by a governing body in perpetuity or for the life of a particular project. The borrowing done for this special and limited purpose constitutes a revenue obligation and does not constitute a general debt of the governing body that created it.

In their relatively brief existence, pollution control bonds have taken on a variety of financing arrangements. But there are certain commonalities in their structure, the most important being the various tests that must be made in order to qualify for tax-exemption. These criteria were not spelled out in detail in the legislation and are the product of lengthy Treasury Regulations.[3]

Pollution control bonds are first and foremost a form of industrial development bond and enjoy tax-exemption only because they are sold for an excepted purpose. Two statutory provisions define what is an industrial development bond (the trade or business test and the security interest test). The pollution control bond, as a financial arrangement, meets both of these.

The trade test applies where a major portion (more than 25 percent) of the bond proceeds are used, directly and indirectly, in a business or trade conducted by a non-exempt (non-governmental) person or entity. This clearly fits the typical arrangement for pollution control bonds. Usually, the issuer sells the bonds and builds or contracts to have the facility built with the proceeds.

The company often acts as the authority's agent in the entire consrtuction process. A lease is set up whereby the company leases the facility from the authority with the payments geared to meet the debt service on the bonds. The firm has the option of buying the facility at the end of the lease. Several variations on this item are possible, including an installment sale agreement or a lease from the issuer to the company for purposes of constructing the facility. Selection of the financing form is usually dictated by tax considerations. In any event, it is patently clear in most cases that the financial facilities meet the trade or business test.

The second test, that of security interest, applies where payments on a municipal obligation are secured by the property, payments on such property, or payments on loans used in trade or business. Usually, it is the pledge of the company's own property or credit to meet the debt that makes the bonds salable. Interestingly, the additional pledge of taxing power by a governmental unit does not alter the security test.

Pollution Control Bonds meet the above tests for Industrial Development Bonds and therefore enjoy tax-exemption solely through the exception granted them by Section 103(c)(4) of the Code and governing regulations. The pollution control exception regulations, as elaborated by various rulings are, again, complex.[4]

Generally, the regulations place heavy emphasis on the relationship of the pollution abatement improvement to the overall industrial process and its design. The stickiest point comes in showing, as is required by the regulation, that two significant purposes are met:

—The improvement would not have been made but for the purposes of pollution control.

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[2] John Cremeans ,"Capital Expenditures by Business for Air and Water Pollution Abatement," *Survey of Current Business* (July, 1974), pp. 58–64.
[3] Treasury Regulations, Secs. 1.103–7 through 1.103–12.
[4] Treasury Regulations, Sec. 1.103–8.

—It is not designed to significantly meet any purpose other than pollution control.

Unless both these tests are met, only that increment of the expenditure attributable to pollution control—and not materially increasing productive capacity or useful life of the production facility—can be used for the pollution control exception and tax-exempt financing.

In addition, the abatement facilities must be certified by some governmental entity as meeting current control standards and substantially all of the proceeds of the bond sale (90 per cent) must be used for pollution-control use.

The incremental expenditure for pollution control has raised many technical and legal questions, in the application of the exception. Perhaps the most celebrated to-date is the effort of private electric utility companies to get the Internal Revenue Service (IRS) to rule that radiation protection expenditures on nuclear reactor plants are for the purposes of avoiding pollution. Such expenditures run from 15 to 35 per cent of total nuclear power plant costs. At stake are billions more in potential pollution control financing. No published decision has yet been reached.[5]

ADVANTAGE TO THE FIRM

Aside from helping to clean up the environment, the tax-exempt pollution bond—much as its predecessor and companion, the industrial development bond—possesses several advantages for the company. First, if not invariably foremost, is the saving in interest cost on borrowed capital (or the lower lease payments) due to the tax-exemption feature. This will vary, as will be seen later, but, by and large, given the basic creditworthiness of the firm or its guarantor, pollution control bonds have sold at yields between 70 and 80 per cent of those on comparable corporate, taxable securities. In recent markets, this has meant an evident savings of 1.5 to 2.0 percentage points by virtue of selling tax-exempt. This can mean a gross savings of about $4 million in total interest expense on a 20-year $10 million issue.

In addition to the interest cost savings, certain Securities Exchange Commission (SEC) registration fees and related legal expenses are avoided because the bonds are not registered. However, pollution control bonds do involve additional costs not found in taxable financing: municipal bond counsels' fees, certain fees to municipalities and local counsels, and the somewhat higher underwriters' spread usually found in the tax-exempt market.

The tax treatment of the acquired facilities can also possess or retain certain advantages. Generally, under the lease (or installment purchase) arrangement, the leasing firm can treat the property as being owned. The company can depreciate the property; take an investment credit; and deduct that part of the lease which is, in effect, interest paid for the borrowed money; and deduct sundry and other expenses involved in the loan. Through more complex arrangements, these tax benefits can be spread to a third party—which leases the property from the authority and sublets it to the company—in order to make maximum benefit of them and lower financing costs.

State and local tax treatment can also provide a source of savings. In some cases the lessee may be exempt from property taxes, sales taxes or construction costs (if done by a public body), and rental taxes (through use of an installment sale).

A final advantage is that of 100 per cent financing of facilities that do not, supposedly, increase the productivity and, hence, the profitability of the plant. Marginal operations, because of the lower cash drains, are able to get financing which might not otherwise be available. In fact, with the 90 per cent substantial use of proceeds rule, firms are able to borrow up to 111 per cent of the pollution facility cost plus $1 million in a straight industrial revenue bond "small issue" exception. The best evidence of the financial benefits involved in the pollution control bond, however, is found in its rapid growth, great use, and nearly universal availability in the States.

TRENDS AND PROSPECTS FOR POLLUTION CONTROL FINANCING

The growth in reported pollution bond sales since their inception in 1971 has been spectacular. Sales as reported by *The Bond Buyer* grew from $93 million in 1971 to $1.8 billion in 1973, somewhat receding to $1.65 billion in 1974 (See Table

[5] Richard Leger, "More Companies Sell Tax-Exempt Bonds for Pollution Control," *Wall Street Journal* (July 8, 1974), p. 20.

1). In the last two years, pollution control bonds have represented about 7 to 8 per cent of all long-term municipal bond sales. Also shown in Table 1 are the yearly sales of "conventional" industrial revenue bonds, many of which are sold in conjunction with pollution control bonds and which have essentially the same characteristics. Adding of these shows that pollution control and development bonds issued on behalf of private firms together represent just about 10 per cent of all reported tax-exempt bond sales.

A major—and evidently growing—difficulty with the figures on pollution control and development bond sales is the widespread nonreporting of transactions. Perhaps the largest unknown factor is the extent to which commercial banks finance such facilities through tax-exempt loans. According to one expert, commercial banks, which in the reported sales figures have accounted annually for only $100 to $200 million in reported purchases recently, actually put away an additional $500 million or more in unreported pollution control loans in 1973 and very likely acquired at least that much in 1974.[6]

Almost all pollution control bond issues are negotiated sales. Correspondingly, many issues are direct placements that are not reported to the financial press or reoffered to the general market. Like the bank loans, tracking down such transactions would be exceedingly difficult because there are not centralized reporting requirements and only estimates can be made. An indicator of the magnitude of unreported issues is the estimate that in the State of Pennsylvania alone combined pollution control and industrial development bonds and loans amounted to $2.4 billion in 1974 of which only $60 million was reported in the financial press.[7] Furthermore, judging by the previous experience of the industrial development bond as examined in a thorough study of its use in the 1960's, it is likely that only three-quarters of the dollar volume of borrowing (and two-thirds of the number of sales) are reported.[8]

Combining these impressions of unreported bank lending and the estimates for unreported direct placements (on the basis of the earlier development bond experience), it is conservatively estimated that pollution control financing and industrial development bond financings were under-reported by at least $1 billion in each of the last two years. This means that actual borrowing has amounted to about $3.0 billion annually in recent years. Of this, approximately $2½ billion would have been for the pollution control purpose. (Moreover, were the Pennsylvania situation to exist elsewhere, such nonreported financing could be higher still.) If tax-exempt bond sales were actually $1 to $1½ billion higher than that reported because of such pollution control and industrial revenue loans, these would represent upwards to 10 to 12 per cent of all tax-exempt long-term borrowing.

Available evidence indicates that pollution control financings will continue to grow. Table 2 gives the dollar volume of pollution bonds pending sale in the market as of several dates over the last year and a half. Like the sale figures, the pending issues climbed steadily. The overhang of planned borrowings evidently has peaked, at least temporarily, at approximately $4 billion. But in view of the surge of borrowing postponements that occurred at the end of last year, it is likely that much of this could be sold were market conditions and IRS rulings to be favorable.

The volume of future pollution control bond financing will depend upon (1) the volume of pollution control investment needed to satisfy pollution control standards, (2) the existence of State and local authorities (or legislation to create them) to sponsor the tax-exempt financing of the bonds, and (3) IRS rulings about what can be financed and possible legislative changes in the Code itself.

FUTURE POLLUTION CONTROL INVESTMENTS

All forecasts show that under existing laws pollution control outlays will climb in the years ahead. But, there is a lack of agreement as to what the magnitude of these expenditures will be. Part of the problem arises from the lack of a good definition of pollution control facility and from the difficulty of attributing capital expenditures appropriately, since expenditures on pollution are often only part of a larger, productive process installation. Be that as it may, it seems that

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[6] John Winders, "Pollution Bonds Off 7.3% in '74," *Money Manager* (January 13, 1974), p. 61, and "Editors Corner," *The Daily Bond Buyer* (February 24, 1975), p. 1.

[7] Letter of Lennox Moak to the Federal Reserve Board (correspondence, December, 1974).

[8] Olin Pugh, *Industrial-Aid Bonds As a Source of Capital Developing Regions*, Essays in Economics, University of South Carolina (1971), p. 70.

estimates prepared by the Environmental Protection Agency, McGraw-Hill, and the Bureau of Economic Analysis conform most closely to the definitions actually used by business.[9]

A recent survey initiated by the Bureau of Economic Analysis showed that nonfarm business had spent $5 billion on pollution abatement facilities in 1973 and planned to spend $6.5 billion in 1974.[10] These figures agree with both the McGraw-Hill and EPA estimates for those two years. However, in subsequent years the projections diverge greatly (EPA envisages upwards to $15 billion by the late '70s annually in anti-pollution outlays, whereas McGraw-Hill sees these as leveling off at about $7 billion annually). Assuming that there is no substantial change in the pollution control laws and allowing for inflation, a conservative forecast would be that pollution control expenditures will rise to $10 or $12 billion by the late seventies. All projections show that at the end of this decade, pollution control expenditures will begin to recede through the 1980's as the "catch-up" period gives way to normal expansion and replacement needs.

Comparison of reported pollution bond sales with expenditures tends to indicate that over the past two years, tax-exempt borrowing has financed about one-third of pollution control expenditures.[11] Given the extent of unreported financings and the large overhang of pending issues, it seems more likely that the share of pollution control outlays financed by tax-exempt bonds may already be closer to 40 per cent and approaching 50 per cent. Accordingly, it is probable that pollution control financing will continue to grow, and, depending on the peak level of expenditures and proportion of these funded by pollution control bonds, such borrowings should reach a level of $4 to $6 billion annually in the next few years, under existing laws After that, the volume should drop off, corresponding to the lessened demand for pollution control facilities as has been explained.[12]

AVAILABILITY OF POLLUTION CONTROL FINANCING

Another factor in the past growth of pollution control bonds has been the rapid adoption of enabling legislation in States. As of the end of 1974, all but two states, Washington and North Carolina, evidently had some legislative authority accommodate this type of financing. The State of Washington had passed such legislation and some projects were attempted. However, the Washington State Supreme Court declared the device unconstitutional because it violated the provision against public credit to private enterprise.[13] Reportedly in some other states, such as New Jersey and Hawaii, the necessary legislation is being tested in litigation; as a result, pollution control bond deals have not been consummated. Sales have been reported in at least 37 of the states over the past two years.[14] With the nearly universal availability of the necessary legislation, lack of legal authority at the State level will not present a serious obstacle to the continued growth in pollution control bonds.

Of much greater consequence to the continued use of the device are the Federal laws and complex regulations that permit its use.

CONGRESSIONAL AND ADMINISTRATIVE DEVELOPMENTS

The pollution control bond did not get off the ground until 1971 and then only slowly. While the legal authority to issue such bonds on a tax-exempt basis seemed to be there, underwriters and bond attorneys were understandably chary about being the first boy on the block to bring out a pollution control bond.

A major breakthrough came in August 1972 when the final IRS regulations were promulgated, clearing up many vague and technical aspects of the in-

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[9] G. Peterson and H. Galper. "Tax-Exempt Financing of Private Industry's Pollution Control Investment," *Public Policy* (forthcoming). Manuscript, July, 1974, pp. 13–14.

[10] John Cremeans, "Capital Expenditures by Business for Air and Water Pollution Abatement," *Survey of Current Business* (July, 1974), pp. 58–64.

[11] It should be noted that bond sales will typically precede the flow of investment expenditures anywhere from several months to a few years, depending in the size of the project. Thus the rapid growth in pollution control bonds precedes the expenditures they will finance.

[12] An added complication is that most pollution control bonds are callable in 5 to 10 years. Most have been sold with very high coupons, and if rates start to drop these would be candidates for refunding or advanced refunding. This could add greatly to the future supply of such securities.

[13] "Washington State Supreme Court Overturns Pollution Bond Ruling," *Money Manager*, October 21, 1974, p. 52.

[14] John Winders, "Pollution Control IDB Volume Off," *The Daily Bond Buyer* (January 9, 1975), p. 1.

dustrial bond legislation. Reportedly, the growth in the subgenus known as pollution control bonds had been stymied by IRS, which dragged its feet in giving opinions about the legality of particular deals. While such IRS opinions in advance of financings are not technically necessary to sell bonds, bond counsel—whose opinion is a practical necessity—was not willing to risk an approving opinion without specific guidance from Treasury as to the proposed issue's tax status. It is thought that pressure from the Nixon Administration in 1971 finally prodded IRS into activity.[15] After some experience was gained with successful sales, bond counsel became willing to give an approving opinion on most deals without IRS opinions and the latter also became easier to get.

The early passive resistance to pollution control bonds by the IRS is important in this context because it illustrates a possible obstacle to new and larger applications of the pollution control and industrial revenue bond techniques. These checks evidently have recently come into play with respect to proposed issues of the financing devices for privately-owned nuclear power plants and the building of oil transshipment facilities.

Late last year, Congress began to take renewed interest in the industrial revenue and pollution control bond. In August 1974, The House Committee on Ways and Means amid its pre-election considerations of tax reform and taking notice of the galloping growth of pollution control bonds, tentatively agreed to limit their use to 10 per cent of the cost of new facilities. Curiously enough, it then tentatively agreed to lift the size-restriction on regular industrial revenue bonds from $5 million to $10 million dollars, also removing the restrictions on the one-per-six-year timing of such issues.

However, the following month, the tax-writing committee partially reversed itself and struck the proposed constraint on pollution control bonds. This left the availability of pollution control bonds untouched, and meant, in addition, that corporations could have financed the first $10 million of plant expenditures on a tax-free basis.[16] After a fusillade of protests from the Treasury, MFOA and assorted other groups, the Committee's tentative agreement failed to be reported to the House floor before the end of the Congress.

Before the year was over, the furor started again. In October, the City of Valdez, Alaska, reported it planned to sell up to $2 billion in tax-exempt industrial revenue bonds to finance a terminal for the Alaska pipeline. This ignited another fiery blast from critics. In December, Senator Jackson wrote Secretary of the Treasury, William Simon, demanding that the Administration halt the Valdez deal, citing it as "an unconsiderable abuse of Federal tax loopholes."[17] Congressman Al Ullman of Oregon, expressing astonishment at the proposed scheme, suggested that the Ways and Means Committee (of which he subsequently became chairman) would reexamine the industrial revenue bond provisions in the tax code in 1975.[18] In January of this year, it was announced that the Valdez project has been shelved.

Thus, a final and perhaps the most important determinant of the future use of industrial pollution control bonds is Congressional action either to liberalize or restrict its use through changing the laws that govern its availability. Current indications are that the Ways and Means Committee, which must initiate any changes in the tax code, will take up the uses of tax-exemption in the summer and fall of this year.

THE MARKET PERFORMANCE OF POLLUTION CONTROL BONDS

Several major issues in pollution control bonds surround their performance in and impact on the capital markets. From the standpoint of the industrial borrower, the greater the cost advantage he can realize by borrowing on a tax-exempt as opposed to on a taxable basis, the greater the inducement to use the pollution control bond. But, from the standpoint of the issuer and the public at large, the greater the sales of pollution bonds in the tax-exempt market, the greater the risk that the supply of tax-exempt bonds will grow in relation to the demand for them and that interest rates will rise. This not only adds to the cost of all municipal borrowing, it also reduces the efficiency of tax-exemption as a

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[15] Pamela Archibald, "Pollution Control Financing Grows Up," *Corporate Finance* (August, 1974), p. 22.

[16] John Gerrity, "Ways and Means' Measure Limits Tax Exempts for Pollution Control," *The Daily Bond Buyer* (August 21, 1974), p. 1.

[17] "Jackson Hits Industrial Aid Bond Abuses," *The Daily Bond Buyer* (December 24, 1974), p. 1.

[18] *Ibid.*, p. 19.

subsidy device. In other words, the Federal government (and States and localities with State and local bond interest exemption provisions in their tax systems) must forego higher levels of potential tax receipts in order for the increasing supply of tax-exempt bonds to be sold.

Below, we shall examine the tax efficiency and equity aspects of pollution control financing. Our immediate aim is next to examine the interest cost performance of pollution bonds and their impact on the borrowing costs for governmental borrowers.

There are considerable structural differences between pollution control bonds and the typical tax-exempt bond. They usually are very long-term issues with a single maturity date for repayment of principal. In this respect, they are like corporate bonds and a special subclass of municipal revenue bonds that have a term bond structure. Also, most issues are callable after 5 to 10 years.

As noted, almost all pollution control bonds are revenue bonds, secured solely on the lease or purchase that the public authority will receive from the occupying firm. Therefore, the quality of the credit, in terms of payments risk, is the credit of the lessee-purchaser. Both Moody's and Standard & Poor's rate pollution control bonds. The ratings are typically those of the underlying private firm (or its guarantor). The credit of the local government entity, which acts merely as a financial conduit to the tax-exempt market, is normally not at stake.

To gain an appreciation of the cost savings to the firm, one must compare the rate on the tax-exempt pollution control bond to the interest rate that the firm would have paid had it borrowed in the private market. One way to do this is to compare the interest rates on corporate taxable bonds of similar characteristics to those on pollution control bonds.

Studies of the market performance of pollution control bonds have shown that their yields have varied in relationship to those on comparable taxable and other tax-exempt instruments over time. A study by Salomon Brothers in mid-1973 found that at the outset of pollution control financing in 1971 and early 1972, large issues of bonds typically reoffered at yields approximately 25 to 45 basis points higher than 30-year general obligation municipals of similar quality.[19] After a break-in period this premium shrank to only 10 to 25 basis points by early 1973, which is roughly the normal rate premium paid on any revenue as opposed to general obligation borrowing. A study done by First Boston Corporation showed approximately the same progressive narrowing of the premium on yields, with the interest spreads between pollution controls and other municipals of similar rating narrowing to practically nothing by early 1973.[20] During 1972 and early 1973, an A or Aa pollution bond borrower was thus able to save about 200 basis points in borrowing cost, on average.

However, by late 1973 and early 1974, the Salomon Brothers' study noted "the pick-up in the volume of tax-exempt pollution control bonds, as well as a heavy volume of utility pollution control bonds has necessitated wider yield spreads."[21] By mid-1973, pollution control issues—beginning to reach an annual sales volume of nearly $2 billion—began to require higher yield premiums (40 to 60 basis points) and the interest cost savings to issuers also began to shrink.

In another recent study, two economists attempted to estimate the relationship of the interest rate differential between similarly rated pollution control and general obligation municipals.[22] Noting that the pollution control issues are not complete substitutes for like-rated general obligation tax-exempts and that the two types constitute different risk classes, they reasoned that interest rate differentials would be sensitive to the relative volume each type of debt constitutes in the market. Using the period October 1972 through 1973, they statistically estimated that the spread between the net interest cost on A or Aa pollution bonds and reoffering yields on 30-year good grade municipals (A to Aa municipals). While there are some technical difficulties with the data used for comparison, their results indicate that when pollution control bonds represent 5 per cent of the dollar volume in the tax-exempt market, the spread between their reoffering yields and those on a like-rated general obligation will be about 50 basis

[19] "Yield Spread of Tax-Exempt IRBs for Pollution Widens Over Municipals," *The Daily Bond Buyer* (July 10, 1974), p. 16.
[20] First Boston Corporation, *Tax-Exempt Pollution Control Financing* (1973), p. 22.
[21] "Yield Spread of Tax-Exempt IRBs," *The Daily Bond Buyer* (July 10, 1973), p. 16.
[22] Peterson and Galper, *op. cit.*, pp. 27–28.

points, but were they to be 30 per cent of the market, the spread would widen to approximately 110 basis points.[23]

RECENT TRENDS IN POLLUTION CONTROL RATES AND SAVINGS

To update these analyses, we have reviewed all reported pollution bonds sold during 1974. In Table 3, long-term reoffering yields for pollution control bonds are compared on a monthly basis to the reoffering yields on similarly rated corporate and municipal issues. The table's figures indicate that the premium on new issue pollution bond yields increased to approximately 120 basis points over like-rated municipal general obligation bond issues (or 100 basis points over like-rated municipal revenue bonds). Correspondingly, there has evidently been some erosion as of late in the savings to corporate issuers, which in early 1974 were running 250 to 300 basis points, but subsequently slid to about 175 basis points on average by the end of the year. Whereas at the beginning of 1974, firms were able to capture about 77 per cent of the advantage of tax-exemption in the form of reduced borrowing costs, by the end of the year they were enjoying only 60 per cent of the spread between taxable and other tax-exempt bond yields.

These results verify that, while the net interest cost savings continued to be appreciable, the premium on pollution control issues has eroded as their volume has grown. This means that tax exemption is increasingly less efficient as a vehicle to lower the interest cost of pollution control bonds and that, in order to sell all of the bonds desired, issuers must pass more of the benefits of the tax exemption to the investors and retain less for the benefit of the firm and improvement which is being financed.

Much of the market performance of the pollution control bond—and the way that it influences overall market yields—is explained by the structure of the instrument and the nature of its buyers. Pollution control bonds have a much longer life than the typical tax-exempt security. Chart 1 illustrates the percentage composition of both pollution control bonds (based on 1974 market data) and all other municipal securities (as estimated from earlier data). As may be seen, pollution control issues exert their heaviest demand on the long end of the market (the average life was calculated at 24.3 years) whereas other municipal obligations are typically much shorter in maturity (an estimated average life of 15 years).

The long life of the pollution control bonds makes them especially attractive to (and reliant upon) two types of investors, individuals and fire and casualty companies. Data supplied by Dr. Ronald Forbes, State University of New York at Albany, provide a useful insight into the importance of fire and casualty companies to the pollution control bond. Using recent reports of individual fire and casualty company security holdings, it is estimated that in 1973 these investors bought approximately 55 per cent of the dollar volume of pollution control bonds reportedly sold that year ($1.0 of $1.85 billion).[24] Practically all purchases were in the 20- to 30-year term bond area, implying that the residue of long issues were taken up by individuals, with banks most likely taking the shorter maturities. The estimated $1 billion in pollution control issues bought by fire and casualty companies represented about 30 percent of their net acquisition of municipal bonds in 1973. It is interesting to calculate that (assuming pollution control issues and other tax-exempt issues had about the same maturity structures in 1973 as that depicted in Chart 1) pollution control issues probably represented over 20 per cent of the total dollar volume of new issue tax-exempts with a maturity of 30 years or longer.

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[23] On a 25- to 30-year term bond (which most pollution control bonds are) the reoffering yield is typically 3 to 10 basis points lower than the net interest cost (to compensate the underwriters). Where serial maturities are involved, the net interest cost is frequently lower than the 20 to 30 year reoffering yield because of the lower coupons on the shorter maturities. Pollution control bonds are a form of revenue bond. Since conventional revenue bonds sell at yields of 10 to 20 basis points above those on otherwise similar G.O.s, comparisons of pollution control yields to those for general obligation bonds overstate the premium investors charge in comparison to alternative (i.e. revenue) tax-exempt obligations.

[24] The sample included 18 stock and mutual companies of various sizes, representing 57 per cent of total industry assets. The companies in the sample held 30 per cent of the dollar volume of pollution issues reported sold by *The Daily Bond Buyer* in 1973.

IMPACT OF THE YIELDS OF OTHER MUNICIPAL BONDS

Calculation of the net impact of pollution control bond offerings on the borrowing costs of other tax-exempt borrowers is replete with difficulties. Basically two avenues to estimates are available: (1) authoritative opinion of market practitioners and observers; and (2) statistical analyses that attempt empirically to estimate the impact of changes in bond volume on the level of municipal bond rates. As we shall see, both sources evidently confirm that pollution control issues do apply upward pressure to the overall level of tax-exempt rates because they compete for a limited supply of funds that seek tax shelter.

The way in which pollution bonds affect the market may be clarified by a brief description of the nature of the municipal market.

Tax-exempt bonds are primarily attractive to higher marginal tax-bracket entities. At any one time the supply of funds available for investment in a marginal tax bracket is reasonably fixed and more funds can be attracted to a particular security only by increasing its yield to a level sufficient to attract those funds. Hence, a greater supply of tax-exempts, everything else being equal, will demand relatively higher rates of return to clear the market of the available securities. An added fillip is that in periods of monetary tightness, tax-exempts frequently see the demand of commercial banks wane and, consequently, municipal borrowers must rely more heavily on individual investors and fire and casualty companies. Usually—but not always—this means that the ratio of yields between comparable tax-exempts and taxable securities grows larger, as more bonds must be sold to individual investors in particular.

The heavy demand for long-term tax-exempt funds and high yield opportunities offered by pollution control bonds provide some initial insights into their impact on tax-exempt interest rates. Table 4 gives for 1974 a four-way comparison of 30-year bond yields for prime and medium grade general obligation bonds, good grade dollar bonds (large term revenue bonds) and good grade pollution control bonds. Examination shows that all the rates climbed steeply, but that those on pollution control and dollar bond issues moved in closest relationship and swelled increasingly above the prime bond yield. Medium-grade general obligation yields rose less, but by more than those on prime bonds, and they moved about half way in between the prime and pollution control yields. Historic highs opened in the interest rate spread between medium and prime quality issues during the year.

Yield series moving sympathetically do not in themselves say anything about casuality, but, in an increasingly quality-conscious market, as in 1974, the high yields on good grade pollution control issues surely exerted great pressure on other high yielding tax-exempts. While assorted energy problems and city fiscal concerns may have accounted for some of the expansion in quality spreads, the continued onslaught of pollution control issues no doubt contributed to the sag in tax-exempt prices. Not surprisingly, informal discussions with dealers confirm that the pollution control bond—carrying strong yield premiums—can exert 25 basis points or more in upward pressure on similarly structured, lower grade general obligation or revenue bonds for conventional public purposes.

George Peterson and Harvey Galper, in their study of pollution bonds, employed a statistical model to relate overall municipal yields to yields on comparable corporate bonds and the composition of the investment sources for municipals. The equation was fit for the period 1973, a relatively good year for municipals in which tax-exempt yields performed well in comparison with those on taxable securities. They estimated that during this period an additional one billion in bond sales each quarter (four billion dollars per year) would increase general municipal rates by 13 to 20 basis points, depending on the particular municipal rate used for comparison.[25]

Other statistical models, based on data for longer periods of time, may provide additional evidence about the effect of the additional borrowing represented by pollution control bonds under varying credit conditions. Examination of two such statistical models implies that an additional billion of tax-exempt borrowing annually during the interval of 1968 through 1970 (moving from a period of monetary ease to one of severe tightness) would have caused tax-exempt

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[25] Peterson and Galper, *op. cit.*, pp. 25–26.

rates to increase by 10 to 20 basis points, on average. This represents a more severe effect than that estimated above using the relatively placid year of 1973.[26]

On the basis of these econometric studies, it appears that the interest rate impact of additional tax-exempt debt—given the sources of funds to the tax-exempt market—probably ranges between 5 and 20 basis points per billion of additional borrowing. The exact magnitude will oscillate and depends on monetary conditions and the degree of absorption demanded of the household sector in particular. Of course, overall cost impacts might be slightly less, since the yields on shorter maturities should be somewhat less affected.

COSTS AND BENEFITS

Pollution control bonds should be examined in terms of their overall costs and benefits as a form of tax subsidy. The subsidy offsets part of the expenses incurred by private industry to reduce or eliminate industrial pollution. Strictly speaking, since the clean-up expenditures are mandated by law, the subsidy does not act as an incentive to such expenditures but, rather, lowers the cost of outlays that must be made in any event. Still, the lower costs achievable with tax-exempt borrowing may lessen the resistance of firms under orders to remedy their pollution problems.

The subsidy's costs are borne by the public through three major avenues:

1. Federal taxes on interest income are foregone when tax-exempt bonds are used instead of taxable securities. (The existence of this subsidy element is clear from the fact that the borrowing for the mandated improvements was required.)
2. Some State and local taxes are foregone because of the exemption of such bonds from many of the states' income, personal property and certain other property taxes.
3. Increase borrowing costs to other tax-exempt bond issuers because the increased supply of bonds pushes up rates of interest, as we have discussed earlier.

The benefits are distributed between the principal target, the firm making the control improvements, and an unintended beneficiary, the tax-exempt bond purchaser of pollution control bonds who acquires enlarged tax shelter for otherwise taxable income.

Cost-benefit analyses are usually controversial; but, they have the obvious benefit of making explicit impacts and the assumptions behind them. The tax-exempt bond market has been the subject of several such analyses, one of which has already attempted to set up costs and benefits for pollution control bonds.[27]

Table 5 displays the primary factors in the national aggregate of costs and benefits involved in pollution control issues for 1973. The main assumptions by which these figures are derived are discussed in the notes to the table.

Looking only at 1973, we see that the $2.1 billion sales in pollution control and industrial revenue bonds meant that an estimated $50 million in Federal income tax revenues were foregone by the exemption of interest on new issues sold that year. (Since these bonds probably had an average life of about 25 years, that means a total of $1¼ billion in Federal taxes will be foregone over their lifetime.) In addition, State and local tax systems lost an estimated $3.4 million in foregone income tax revenues, to make the total one-year governmental tax an estimated $54 million in 1973.

The next item is one we have already discussed, that of increased State and local borrowing cost. Galper and Peterson estimated that overall pollution control

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[26] See Peter Fortune, "Impact of Taxable Municipal Bonds: Policy Simulations With a Large Econometric Model," Federal Reserve Bank of Boston (1974) and Harvey Galper and John Petersen, "An Analysis of Subsidy Plans to Support State and Local Borrowers," *National Tax Journal* (June, 1971). In the latter study, a set of statistical equations were estimated relating the supply and demand of municipal bonds to rates of interest in the market (among other things). These were based on regressions fit for 1962 through 1970 and the coefficients were used to simulate behavior under alternative bond market conditions. The results indicate that under market conditions where the ratio of tax-exempt to taxable rates was .78, an extra billion in tax-exempt borrowing would be associated with about a 20 basis point rise in tax-exempt rates.

In view of the growth in the market, it might be better to adjust the estimate by looking at the relative changes in interest rate and volume (elasticity of interest rates with respect to bond sales). Using this measure, we find that a 10 per cent rise in bond sales implies a 4 percent increase in the bond rate. Thus, for example, moving from $20 to $22 billion in tax-exempt sales would push rates up by 24 basis points (from 6 to 6.24), or 12 basis points per billion in additional borrowing.

[27] Galper and Peterson, *op. cit.*, p. 33, et. seq.

bonds lifted municipal rates by 6 basis points (.06 per cent) in 1973. While the rate effects may have been more severe in the long-end of the market and for revenue issues, that estimate for the market rates as a whole appears reasonable. Hence, for the $21 billion sold of other municipal tax-exempts, this would mean a one-year additional interest cost of $12.5 million. The overall governmental cost of the subsidy adds up ot $66 million for the year 1973.

Looking at the benefit side, firms using pollution bonds saved an estimated 190 basis points in interest rates, on average, in 1973. This, times the dollar volume of bonds sold, sums to $50 million in reduced loan costs. The other $26 million of the subsidy flow to investors in terms of additional tax shelter income. In other words, of the total subsidy outlay by government, industrial firms were able to enjoy only about two-thirds of it, the rest being passed on to pollution and industrial revenue bond purchasers. While many technical items of such analyses may be arguable, the magnitude and direction of the results are quite clear: tax-exemption is a relatively expensive—and inefficient—way to cut the costs of cleaning up the environment. And, while the Federal taxpayer foots most of the bill, the State and local sector comes in for a not inconsiderable share.

SITUATION BY 1980

While the 1973 figures are impressive, they are largely a dead letter; the bonds have been sold and the subsidies are largely sunk costs to be incurred over the next 25 to 30 years. The real issue is one of future growth. With the long life of the pollution bond and—as witnessed in 1974—its ability to help drive up rates in periods of tight money, one must look ahead to the cumulative impact on the remainder of the tax-exempt bond market. To estimate this impact, one must make several assumptions, but those shown in Table 6 are conservative: an annual average of $25 billion in other tax-exempt sales and of $3.5 billion in pollution control and industrial revenue bond sales 1975 through 1980, leading to respective outstanding debt totals of $150 billion and $25 billion.[28] This is combined with an assumed average pollution control bond rate of 6.25 (a savings of 175 basis points and a premium of 60 basis points over tax-exempt general obligations).

Collecting the above factors, we find that by 1980, the total tax loss on all outstanding pollution control (and industrial revenue bonds) issued during the decade of the '70s would be $640 million for 1980. In addition, State and local governments by then would be paying an additional $150 million each year in debt service cost because of the 10-basis point hike in interest cost resulting from insurance of the industrial aid debt. On the $25 billion outstanding in pollution control bonds, corporations would enjoy a total of $425 million in interest savings and investors would be receiving about $365 million in added tax-sheltered income. In that case, firms would be realizing only about 54 per cent of the benefits of tax-exemption. How much of this cost reduction would pass on to the consumer in the form of lower costs is simply not estimatable; but there is certainly no guarantee that much of it would or that the incidence of lower prices would compensate those taxpayers having to pick up the tab for the foregone taxes.

The above estimates, when compared to what could be the impacts, are conservative. For example, were the stock of outstanding pollution bonds to be $40 billion by the end of 1980 (rising from $4.5 billion at year-end 1974), the interest cost impacts and foregone tax revenues could push the annual total costs of the subsidy to nearly $1½ billion by the end of the decade.[29] Or, even with gross sales at only $2 or $3 billion a year, but with continued credit tightness in the long tax-exempt market, it is quite possible the increase in municipal rates could be greater. For example, an increase of 15 to 20 basis points would increase the annual debt service on the $150 billion in conventional tax-exempt bonds issued in the face of the higher rates, to $200 to $300 million by 1980. In either instance, it is also likely that the interest rate advantage to industrial issuers would be further pinched and that the surplus flowing to investors would be heightened. Galper and Peterson in their high volume projections of

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[28] We are concerned only with those tax-exempts issued from 1974 through 1980. After allowing for retirements of some of the bonds sold, this leads to outstanding figures shown above.

[29] *Ibid.*, p. 33. Galper and Peterson estimate one billion would be foregone Federal taxes, with State and local government costs from taxes foregone and added borrowing costs totaling another $450 million.

pollution control financing demonstrate a situation where by 1980, industrial borrowers enjoy less than 40 per cent of the subsidy in reduced costs.

It is the surplus to those tax-shelter investors who can acquire the pollution control bonds and the willy-nilliness of the incidence of final benefits that call to question the equity of the pollution bond interest exemption. Some believe that a direct tax writeoff or some other form of explicit subsidy would be preferable to the present tax-exempt financing of the pollution control outlays, a topic to which we shall return shortly.

SOME OTHER CRITICISMS OF POLLUTION CONTROL BONDS

The unfavorable impacts on the State and local bond market and the overall poor marks on efficiency and equity grounds that the pollution bond subsidy registers are not the only criticism leveled on the device. Two other complaints are its relative lack of availability to small borrowers (and, conversely, its overuse by large firms that could finance control facilities by other means) and its potential for undermining the concept of tax-exemption.

It has been argued that the pollution control problems of small firms are not met by the pollution bond. The substance of the argument is that small borrowers, because they lack market recognition and credit quality and find bond financing costs prohibitive for their small issues, are effectively barred from use of the tax-exempt pollution control bond. As a result, they are restricted to short-term bank loans and must borrow at higher costs. This places them at a competitive disadvantage with respect to larger firms. Small business pollution control expenditure needs have been estimated at 15 to 30 per cent of the total for U.S. industry.[30]

Inspection of reported pollution control bond sales does seem to confirm that most are done on behalf of big corporate borrowers. The average size of pollution control issues in 1974 was about $15 million. To help rectify the small business situation, legislation providing Small Business Administration loan guarantees to pooled tax-exempt pollution control bonds has been proposed.[31] While this would not correct the subsidy's efficiency problems that were reviewed, it could be argued that at least it would spread benefits of interest savings more equitable to smaller polluters.

A final argument against the pollution control bonds has to do with its political implications for all other borrowers who now benefit from tax-exemption, specifically State and local governments. First, those with a strict-constructionist view of governmental functions hold that pollution control issues are essentially and predominately aids to private firms and, therefore, do not constitute a philosophically defensible use of public credit. To the pragmatist, the danger is compounded by the impacts of pollution control on the efficiency of tax-exemption arising out of the increasing costs to local borrowers, increasing Federal tax avoidance, and, conversely, the growing surplus accruing to tax-exempt bond purchasers.

The convergent outcome of both these lines of reasoning is that large scale abuse or misuse of tax-exemption, even if sanctioned by the Internal Revenue Code, is as unwise as it is unwarranted. Opponents argue that, by lessening tax-exemption value and debasing its application, pollution control bonds threaten to swamp and sink the concept of tax-exemption altogether:

"If these financing practices continue at the present rate, they will cause a serious deterioration of the tax-exempt market, the result being that borrowing costs for whatever purpose will become prohibitive. The decline of credit quality, the increase in interest costs, etc., can and will lead to sharper pleas for Federal intervention and subsidies. Thus, another step toward a breakdown of local government and the demise of the tax-exempt bond." [32]

ALTERNATIVES TO TAX-EXEMPT POLLUTION BONDS

The use of tax-exempt bonds for pollution control investment helps to reduce the cost of such investments. Two major alternatives exist to this continued use of tax-exemption; (1) force industry to find other, privately financed ways to clean-up the environment; or (2) employ an alternative form of subsidy.

The case for not subsidizing pollution control investments is that pollution is a real cost of production that via the price mechanism should be passed on to

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[30] *A Pollution Control Financing Program for Small Business*, Bank of America Res. Dept., (n.d.), p. 2.

[31] *Ibid.*, p. 3.

[32] Harlan Boyles, quoted in "N.C. Treasury Urges Defeat of IDB Amendment," *The Daily Bond Buyer* (November 1, 1974), p. 20.

the consumer. By doing this, consumption of goods that are costly in terms of the resources needed for their production will be discouraged. If consumption can be sustained only by a partial increase in prices, but production is still profitable, then part of the cost is absorbed by a reduction in the return on capital. The argument against this is typically one of hardship on the part of industry or consumers. Private absorption of the costs would mean closing or relocating certain plants, losses to foreign competition, unemployment, reduced profits and stock prices, and a host of other product and site-specific disasters that are unacceptable.

Looking at the alternative subsidy forms, those devices that favor plant and capital expenditures—such as the pollution control bond—have been criticized on the basis that they foster use of capital-intensive technology when other clean-up modes are available. However, the mobility of capital goods is realistically an asset when it comes to avoiding the trauma of radical moves of and changes in processes. Furthermore, as noted, the imposition of standards practically dictates certain technologies that typically are extremely capital-intensive.

Subsidies can be and are used in order to distribute the burdens of clean-up costs and to recognize the harmful side effects of those costs were they to be entirely borne by the private markets. Several alternative forms are available. Subsidies may be either direct or provided through the tax system, as is the case with tax-exempt pollution control bonds. At present, pollution control expenditures by industry on plants built before 1969 are allowed an accelerated 5-year depreciation rather than useful life depreciation. The cost of this tax subsidy has been estimated by Treasury at $35 million a year (1974).[33] Firms using the accelerated depreciation for pollution control investment cannot also take the investment tax credit.

It has been suggested that the accelerated depreciation feature be extended and broadened to include all new pollution control expenditures. Concurrently, the use of pollution control bonds would be prohibited for all new capital construction and would be permitted only in conjunction with older plants.[34] Another approach might be like the proposed lifting of the investment tax credit to 12% for utilities (heavy users of pollution control bonds) while removing the 50% limit on income tax liability that the credit could offset. Similar tax subsidies for all pollution control expenditures could be an attractive trade-off against continued use of tax-exempts. While the argument might be advanced that tax write-offs only help profitable companies, it would be noted that unprofitable companies are not receiving any relief by pollution control bonds, since they are secured on the creditworthiness of the underlying firm.

In terms of direct subsidies, tax-exempt bond issues could be replaced by a direct subsidy for pollution control bonds sold on a taxable basis.[35] Such subsidized taxable bonds have already seen limited usage. It is agued that a direct subsidy would be more efficient than the present method of tax-exempt financing: the subsidy would lower tax-exempt rates in relation to taxable yields and its cost would be largely offset by increased Treasury revenues. Furthermore, it has been demonstrated that a mandatory sale of pollution control issues on a taxable basis (with a subsidy) would be less costly for Treasury than an optional sale, although either method would lower the costs of other tax-exempt borrowers. In either event, a subsidized taxable bond would shift most of the load off of the State and local governments that now partially finance the costs of pollution control subsidy provided by tax-exempt borrowing.

Alternative subsidy mechanisms need to be examined vigorously as to the comparative size and incidence of their costs and benefits for given goal and rate of evironmental improvement. As of late, it has become abundantly evident that pollution control, energy conservation, price stability, and capital market capacity and efficiency are inextricably intertwined. Study of any one in isolation is a hazardous way to prescribe policy that affects all. The natural limitation of the tax-exempt bond market, the rapid dilution of its cost-reducing benefits in the face of an over-supply of debt, the largely hidden but sizable costs and leakages resulting from inefficient operation, and the general erosion of the tax-exempt privileges—all dictate that search among alternatives be given top priority.

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[33] "Tax Expenditures," *Special Analysis of the Budget Fiscal Year 1976*, Washington, D.C. (1975), p. 108.

[34] Edward Renshaw and Michael Bell, "Public Money and Private Pollution," *Governmental Finance* (November, 1974), p. 18.

[35] Renshaw and Bell, *op. cit.*, p. 16. Galper and Peterson, *op. cit.*, p. 37.

CHART 1.—Percentage distribution of the dollar volume of maturities: Comparison between new issue pollution control bonds and other municipal bonds.

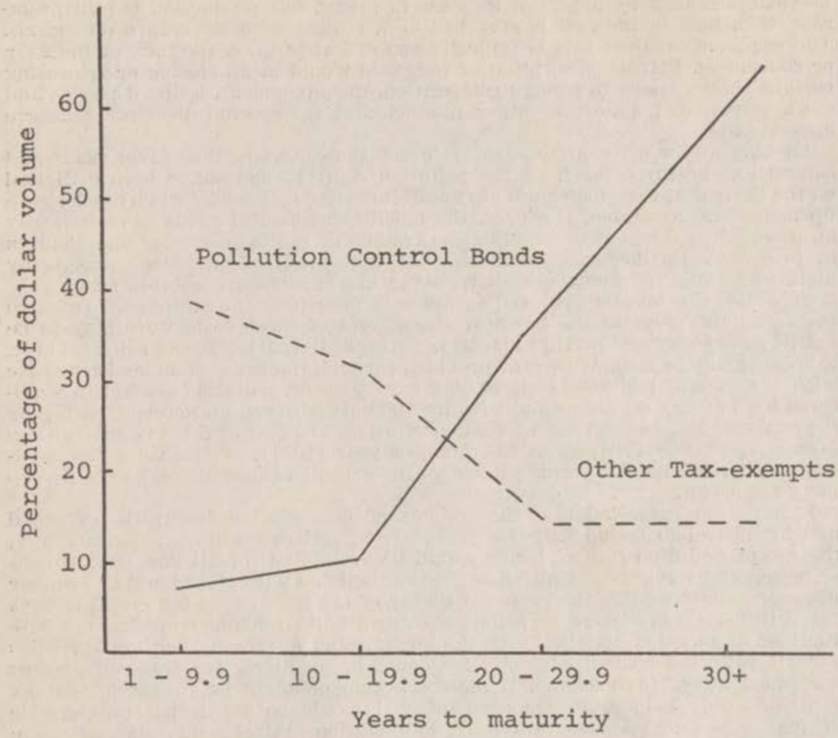

TABLE 1.—REPORTED BOND SALES

[Dollar amounts in millions]

Year	Pollution control	Industrial development	Total PC and ID	Total tax-exempt bond sales	PC and ID as percent of total
1970		$110	$110	$18,160	0.6
1971	$93	194	287	24,370	1.2
1972	594	296	890	22,940	3.9
1973	1,850	270	2,120	22,950	9.2
1974 (estimate)	1,650	330	1,980	22,700	8.3

Note: As explained in text, actual bond sales and loans for pollution control and development purposes are likely to be $1,000,000,000 greater than the reported amount. On the basis of fragmentary experience, the total could be higher still.

Source: The Daily Bond Buyer (various issues), Securities Industry Association Municipal Statistical Bulletin (various issues), and G. Peterson and H. Galper "Tax-Exempt Financing of Private Industry's Pollution Control Investment."

TABLE 2.—POLLUTION CONTROL BORROWING REPORTED AS PENDING

[In billions of dollars]

Date of report [1]	Amount pending
October 1973	$0.95
January 1974	1.24
June 1974	2.08
October 1974	[2] 4.02
January 1975	[2] 3.81

[1] As reported by the Money Manager (various issues).
[2] Includes $260,000,000 in Washington State pollution control issues now in litigation.

TABLE 3.—COMPOSITE YIELD, SAVINGS, AND PREMIUMS ON POLLUTION CONTROL BONDS REPORTED SOLD IN 1974

[Figures in percentage points]

Month	Yield [1]	Savings [2]	Premium [3]
January	6.04	2.27	0.67
February	6.49	2.42	.79
March	6.25	2.28	.63
April	6.10	2.52	.49
May	6.56	3.02	.58
June	7.33	2.66	.86
July	7.66	3.03	.78
August	8.26	2.47	1.16
September	7.79	2.30	1.01
October	8.12	2.34	1.26
November	7.98	1.74	1.21
December	8.27	1.72	1.11
Average	7.24	2.38	.88

[1] Yield is the reoffering yield on the longest maturity (usually 25 or 30 yr).
[2] Savings is the difference between the pollution control reoffering yield and that estimated for like-rated and maturity corporate and utility issues. (Salomon Bros. rate series were used.)
[3] Premium is the difference between the pollution control reoffering yield and that estimated for like-rated and maturity tax-exempt general obligation issues. A total of 107 issues are included, ranging from 5 to 17 each month.

Note: All figures are weighted averages.

TABLE 4.—REOFFERING YIELDS FOR 30-YR TAX-EXEMPT BONDS, MONTHLY, 1974

Month	General obligation [1]		Pollution control [2] (Aa, A)	Dollar bonds [3] (Aa, A)
	Prime	Medium		
January	5.15	5.50	6.10	5.90
February	5.20	5.45	6.20	5.90
March	5.35	5.65	6.10	5.95
April	5.65	6.00	6.35	6.20
May	5.80	6.30	6.60	6.40
June	6.05	6.60	7.10	6.85
July	6.25	6.80	7.45	7.35
August	6.35	7.05	8.00	7.20
September	6.30	7.10	7.80	7.50
October	6.25	7.05	7.90	7.55
November	6.35	7.15	7.50	7.45
December	6.60	7.35	8 25	8.10
Change, January to December	1.45	1.85	2.15	2.20

[1] Figures quoted under general obligation heading are based on the Salomon Bros. weekly municipal bond yield series found in "Bond Market Roundup" for January to December 1974.
[2] The pollution control bond series is the weighted average of reoffering yields for 25- to 30-yr maturities for all pollution control bonds carrying an Aa or A rating. Source is the "Results of Bond Sales," The Daily Bond Buyer, January to December 1974.
[3] Bid-price yields as reported in "Municipal Dollar Bonds," The Daily Bond Buyer, January to December 1974, for the following high-couponed issues: Delaware River Port Authority ('10); Kentucky Turnpike Authority ('08); Nebraska Public Power System ('13); New Jersey Turnpike Authority ('09); and New York State Power Authority ('10).

TABLE 5.—AGGREGATE COSTS AND BENEFITS FROM POLLUTION CONTROL BONDS ESTIMATED FOR THOSE BONDS SOLD IN 1973, 1ST YR COSTS ONLY

[Dollars in millions]

	Amount
Governmental costs:	
Federal income taxes foregone	$50.4
State and local taxes foregone	3.4
State and local borrowing cost increase	12.5
Total costs	66.3
Private benefits:	
Interest savings of borrowing firms	39.9
Added income to tax-exempt bond holders	26.4
Total costs	66.3

Note: Conditions and assumptions: P.C. bond sales (includes IRB's) $2,100,000,000; other tax-exempt bond sales, $21,000,000,000; average pollution control rate 6.1 percent; alternative corporate bond rate, 8 percent; increase in average municipal rate, 6 basis points; Federal marginal tax rate, 0.30; and, State and local marginal tax rate, 0.02. See text and Peterson and Galper op. cit., pp. 33–35.

TABLE 6.—AGGREGATE COST AND BENEFITS FROM POLLUTION CONTROL BONDS, A FORECAST FOR 1980 FOR POLLUTION CONTROL BONDS OUTSTANDING

[Dollars in millions]

	Amount
Government costs:	
Federal income taxes foregone	$600
State and local taxes foregone	40
State and local borrowing cost increase	150
Total costs	790
Private benefits:	
Interest savings of borrowing firms	425
Added income to tax-exempt bond holders	365
Total benefits	790

Note: Forecasted conditions: Total outstanding pollution control bonds, $25,000,000,000; other tax-exempts sold since 1972 then outstanding $150,000,000,000, average corporate rate during period, 8 percent; average pollution control rate, 6.30 percent average increase in municipal bond rates, 10 basis points, Federal marginal tax rate, 0.30; State and local marginal tax rate 0.02.

MUNICIPAL FINANCE OFFICERS ASSOCIATION, WASHINGTON, D.C.

RESOLUTION ON POLLUTION CONTROL BONDS

Whereas the rapid growth and high level of industrial aid bond sales by State and local governments to finance pollution control facilities for private firms has increased the borrowing costs for State and local borrowers, and

Whereas such a method of Federally subsidizing private pollution control facilities, if unrestrained, is inefficient and costly, for both the Federal government and State and local government, and

Whereas continuation of this financing device has contributed to the erosion of the value of tax-exemption and places in jeopardy the benefits of tax-exemption for traditional governmental purposes, and

Whereas the MFOA previously has opposed unconstrained use of what is commonly called industrial aid financing for basically private purposes: be it

Resolved That MFOA expresses its opposition to exemption from Federal income taxes of interest paid on debt sold for purposes of financing pollution control facilities for private firms, and urges that, to the fullest extent feasible, the Federal government provide pollution control assistance deemed necessary through mechanisms other than issuance of tax-exempt securities, and be it further

Resolved That to such extent as the Congress of the United States chooses to grant tax-exemption on a selective basis to certain preferred uses of pollution control debt, the MFOA urges that there be suitable restrictions limiting such tax-exempt financing narrowly to pollution control costs with restrictions on the size and frequency of borrowings for such purposes and that such tax-exempt issues be limited to projects that are in conformance with comprehensive State plans and that all such transactions be required by said States to be fully reported to the public.

Adopted April 30, 1975.

Mr. ROSENTHAL. Thank you very much for a thoughtful and enlightening statement.

Congressman Levitas?

Mr. LEVITAS. On the last point you made about public information, it is my understanding that municipal bonds are exempt from registration under the Securities and Exchange Act. However, I also understand that in recent months there has been some question as to whether the underwriters or others who deal in the marketing of these bonds are subject to the requirements of the Securities and Exchange Act 10(b)(5). What is the situation on that?

Mr. PETERSEN. The underwriters and issuers are exposed to 10(b)(5). State and local issuers are not exempt from that section. They are exempt from registration requirements in the 1933 act but State and local government, officers in State and local government, as well as underwriters and other market participants are still subject to the antifraud provisions of the Securities Act, 1933.

Mr. LEVITAS. Has there been much utilization, either by the investing public or by the Commission itself, on disclosure of information or enforcement of these requirements with respect to inadequate information?

Mr. PETERSEN. In terms of inadequate information, outside of the opinion of a material fact, I would say perhaps not. But, to answer your question more directly; yes, there have been actions taken. I believe there have been seven enforcement actions taken by the SEC in roughly the last 2 years involving 70 parties in the municipal bond area.

None of those 70 parties was a municipality or one of its officers. It has been exclusively in the area of dealers and underwriters of the bonds.

We are in the process, as I said before, of developing disclosure statements, attempting to meet what I honestly believe is a newly found need in the market for more and better information. The Securities and Exchange Commission is aware of this effort and is participating in it, which, I might point out, is in part funded by the National Science Foundation. I hope that is a project of which Senator Proxmire might approve.

Mr. LEVITAS. I don't know whether you want to focus specifically on the situation of New York City, but in the event which we hope will not occur, that New York City were to default on the short-term obligations, is it likely that 10(b)(5) action either by the Commission or by private investors might follow such an event?

Mr. PETERSEN. I am really not qualified to answer that question. Outside of the general observation that the financial crisis in New York City has probably been one of the best covered news stories of the year, it certainly has not been conducted under any blanket.

Mr. LEVITAS. One point you made I found to be very interesting and really had not considered previously. You observed that if the Federal Government; or for that matter a State government, came up with some kind of program which would provide guarantees for municipal borrowing, and particularly for those which would not be as creditworthy, or even creditworthy without such guanatee, that one of the economic effects would be to make municipal borrowing more costly to those who are able to go to the marketplace without such guarantees because you would be putting people into the market who would not ordinarily be there.

Do I understand your point on this?

Mr. PETERSEN. That is correct. It is a difficult phenomenon to quantify but I think we have enough indications, by knowledge of the behavior of the market, that there would be this impact.

The ratio of rates, for example, between taxable bonds and tax-exempt bonds, that is the closure between the two, is really at the highest ratio, or the smallest gap, right now in the very high quality bonds. In other words, there is a large supply of triple A and double A paper seeking a home, in relation to the demand for those credits.

The banks typically have been those customers most interested in highest grades and those banks are on a vacation from the municipal bond market.

I submit that to inject a lot more very high grade paper would be expensive. As well as credit quality, primary attraction to these bonds will be their ability to provide tax shelter. Unless we do something, number one, to increase the amount of need for tax shelter; or, two, unless we shift some of that supply into another market, then it will mean higher rates to clear the market.

Mr. LEVITAS. Let me oversimplify a conclusion from that statement—that the establishment of a national commission of the sort which has been proposed to guarantee municipal bonds, if implemented, could have the effect of making the availability or the cost of municipal borrowing more expensive or scarcer for those municipalities who would not need to avail themselves of that resource. Is that correct?

Mr. PETERSEN. I believe that is a fair statement. In fact, I think we will see some tests of that hypothesis in the next few weeks—not a direct test, because that is not fair in the case I have in mind. When "Big MAC" comes to the market, borrowing $3 billion between now and Labor Day—and we don't know yet what the rating will be, whether A or double A—we are certainly going to have some way of testing the effects of very, very large issuance of investment-grade paper.

The largest bond issue to date was something in excess of $490 million by New York City about a year ago. The Commonwealth of Massachusetts is coming with $450 million next Monday.

"Big MAC" is coming with $1 billion on their first issue. These are fantastic amounts for the market to absorb in a period when you don't have any net bank support.

Mr. LEVITAS. One last question for my enlightenment, since I don't understand much about this, anyway. Would you explain to me what is arbitrage, how it works, does it have anything to do with the circular A–70, and why was everybody so upset about it?

Mr. PETERSEN. Arbitrage essentially is a phenomenon of being able to borrow at one rate and then investing at a higher rate and thereby earning a profit on the transaction.

In the case of tax exempts it is a possibility, has been a possibility, because the tax-exempt rate, as I said earlier, invariably was lower than the taxable rate.

There were some communities and some borrowers who in the late sixties thought they had found the lodestone to perpetual financial strength by doing this practice. It was banned under extensive regulations. In fact, the regulations are so complex and involved they have never been made final. We have been waiting since 1969 to get final regulations in the area of arbitrage.

In terms of A–70, I think the basic problem with A–70 from the standpoint of OMB and then Director Roy Ashe was the concern that State and local governments, by using either indirect or direct Federal guarantees, were expanding the supply of tax-exempt bonds and, thereby, really allowing too much of an avoidance of Federal tax to suit the taste of Treasury.

Others have said that perhaps it was just Treasury's concern about having a borrower in the market who could borrow at a lower rate than

Treasury. That is facetious, really. It was overall worry about the efficiency of putting out more triple-A tax-exempt paper. After all, the bonds do go at low rates, it is true, but not all of the interest rate savings accrue to the municipality. Much of it accrues to the investor.

Mr. LEVITAS. Thank you.

Mr. ROSENTHAL. Thank you very much for a very enlightening statement.

Our next witness will be Mr. John A. McCart, executive director, Public Employee Department, AFL-CIO.

We are pleased to have you with us this morning. We are anxious to hear your statement.

STATEMENT OF JOHN A. McCART, EXECUTIVE DIRECTOR, PUBLIC EMPLOYEE DEPARTMENT, AFL-CIO

Mr. McCART. Thank you, Mr. Chairman. In view of the time situation I will be happy to summarize the statement.

Mr. ROSENTHAL. Without objection, the entire statement will be inserted in the record.

Mr. McCART. The public employee department consists of 29 international and national AFL-CIO unions which represent workers in the public sector. These involve local, State, Federal, and postal services.

My presentation will be aimed at pointing up the serious problems of the cities as a whole with just a couple illustrations.

It is important for all of us to remind ourselves about the role of the cities in our society—not just the huge population centers but the smaller cities and towns which are in many cases confronted with the same problem today as the major population centers.

Cities traditionally throughout our history have contributed a great deal to our heritage. They are the population centers. They are centers of trade and commerce and cultural centers. They have been responsible in large measure for the tremendous progress we have made in our country.

Therefore, it is important we view with concern the financial status of the cities in this era of our economic downturn.

We tend to think of cities as isolated communities. Yet, with the spread of exurbia these are simply extensions of the cities, some of them developing into megalopolises.

You gentlemen know the basic problem. The cities and States are on a treadmill. Their tax receipts are declining because of unemployment. Some of them are attempting to impose additional tax burdens, which, because of unemployment the citizens are well unable to meet, so we find——

Mr. ROSENTHAL. Can you direct your attention to page 4, the second half, and tell us about the employment separation, what causes them, and what will happen?

Mr. McCART. What causes them is just what I mentioned. The cities find their tax receipts sharply reduced and they have to look for ways to economize.

I listed four or five examples of what has happened.

Mr. ROSENTHAL. This morning Secretary Simon pointed a finger at New York and said its own mismanagement caused the problem and they should fire people. You say in February of 1975 the city of Detroit separated 1,500 employees. Eight hundred workers comprising, Newark, N.J., are likely to lose their jobs.

In Atlanta, Ga., no new employees have been hired since November 1974. Next month, all workers will be expected to donate 1 day's work each month without pay.

Attrition has caused the loss of 600 jobs in the city of Cleveland this year. An additional 500 jobs are anticipated to remain unfilled through the attrition process next year. In this muncipality, 35 percent of the jobs are financed wholly or partially by Federal funds.

The administration in Buffalo, N.Y., is faced with a $23 million deficit or separation of 1,600 workers, who constitute 25 percent of the work force.

It looks as though the workers will have to solve the financial plight of the cities.

Mr. McCart. I agree with you. There is another point involved. These activities by the cities represent a real problem for the citizens in terms of needed services. I am not talking about extraneous or superficial services, but police and fire protection, sanitation services, social services, and health services, those kinds of things which are absolutely essential for the citizen of a community to lead a decent life—even to live.

Mr. Rosenthal. You say Buffalo is faced with the loss of 25 percent of its municipal work force.

Mr. McCart. Yes. If you apply that to whatever proportion will be allocated for police, fire, hospitals, and so forth, you can see——

Mr. Rosenthal. Mr. Simon suggested this morning that New York's problems were caused by mismanagement and failure of political courage. Is that true in all these other cities, too?

Mr. McCart. Mr. Chairman, I have only recited about five examples here. We have a list of 25 or 30 examples illustrating this point which parallel what I mentioned earlier. They are not a matter of mismanagement. It is a matter of cities and States not having the funds to do the job which has to be done for the citizens, and it points up the absolute necessity of finding some kind of financial relief.

Mr. Rosenthal. Mr. Simon suggested financial relief is to fire people and cut back on services. You have another proposal?

Mr. McCart. The proposal which we are supporting in the House and Senate is to provide financial assistance to the cities and States geared to the rate of unemployment. When the rate of unemployment declines the amount of aid would decline, so ultimately the cities will return to being self-sustaining.

Mr. Rosenthal. The suggestion was made by Mr. Simon and others that what the cities really should do is to tighten their belts and live by the American tradition of learning how to manage their households. How do you respond?

Mr. McCart. That is a rather simple approach to a problem which is much more complex. There is evidence that the cities are tightening their belts at the expense of essential services to citizens.

I don't know what else you can expect them to do. If they do not have resources and if their citizens cannot provide them with the tax resources because they do not have jobs, I do not see how we can expect them to work some kind of magic.

I think it is an obligation of the whole Nation to assist these cities because they play a very important role in our economy. It is a national problem. We cannot say to the State or city—solve your own problem.

Mr. ROSENTHAL. Why not?

Mr. McCART. Because they don't have the money, citizens don't have jobs and therefore cannot pay taxes.

Mr. ROSENTHAL. Mr. Levitas?

Mr. LEVITAS. In that last regard, I notice you refer to it in your statement but I would like to have you expand upon it. The jobs bill which was recently vetoed by the President, would that not have directly assisted many municipalities and local governments by providing in this recessionary period the opportunity to continue essential employment and the President's veto of that particular legislation works directly against recovery from the recession?

Mr. McCART. I must emphasize that the presentation we are making on behalf of the cities is only one of a large number of elements necessary to solve the economic crisis in our country. You have to put together public service jobs, public works acceleration, and housing stimulation. Assistance to States and cities is just one facet. The AFL/CIO program, aimed at giving productive jobs to people that will generate money into the economy, is the full answer. We have concentrated on this subject because it is the area of consideration of the committee today.

I agree with you completely, sir.

Mr. LEVITAS. Let me raise a question not because I subscribe to the theory but I think it has been raised before this committee and it certainly has been raised in numerous articles, editorials, and newspapers. That is, first of all, that one of the reasons the cost of local government has gone up so much in the last few years is a consequence of the pressures which municipal employee unions have brought to bear on local governments in demanding and receiving what are said to be unwarranted and unjustifiably high salary increases, wage increases, and this has been the major contributing factor to the plight cities now find themselves in. How do you respond to that?

Mr. McCART. As a generalization I would say public workers as a whole are not ahead of their counterparts in private industry. They tend to follow. It is certainly true in the Federal services and true in most State and local governments.

When you have situations where collective bargaining prevails in the State and local jurisdictions it seems to me you have there two parties at a bargaining table, the union and management.

Management and the union share equally in the bargaining process. If the unions are able to persuade the management that their proposals are justified in light of what management conceives as its financial obligations to its citizens, then I am hard put to place the blame at the door of the unions.

Mr. LEVITAS. One of the consequences which has been suggested of the wage increases which municipal workers and public employees have received over the past few years is a suggestion that it will lead to a reduction in the number of public employees in various municipalities because, as the cost of government goes up, and there is insufficient funding to take care of this gap which is coming about, which we call in part the urban crisis, that cities will begin to do just precisely what your statement says they will do, lay off workers and reduce the work force and try to provide the same services with higher paid but fewer public employees.

What is your response to that?

Mr. McCart. That is certainly a possibility. That is a value judgment which has to be made on a case basis by each jurisdiction.

If the efficiency of the particular government services can be proved I suppose we have to accept our lumps as other people do. However, that is no reason to place the blame on the unions for the financial problems that the municipalities and States are facing.

As I said a moment ago, in most instances public workers are followers rather than leaders in terms of wages and benefits. That is a demonstrable fact.

Our problem on the union side has been to try to place the public employee in a position where he receives equal treatment with his or her private industry counterparts.

Mr. Levitas. Thank you very much.

Mr. Rosenthal. Thank you very much for a very thoughtful and important statement.

Mr. McCart. Thank you.

Mr. Rosenthal. This subcommittee stands adjourned.

[Mr. McCart's prepared statement follows:]

Prepared Statement of John A. McCart, Executive Director, Public Employee Department, AFL–CIO

Mr. Chairman and members of the subcommittee, the Public Employee Department, AFL–CIO, desires to express its gratitude to you and your colleagues for undertaking hearings on a subject of vital importance to the economic welfare of our country—the financial survival of city and state governments.

The Department through its 29 affiliated unions represents in excess of 2 million public workers in state, local, federal jurisdictions, and the Postal Service.

With all the social ills experienced by the cities in recent years, we tend to lose sight of their importance to the social and cultural life of our country. Our population is concentrated in municipal areas. Urban communities have been and will continue to be the fulcrum of our progress. They have received and nurtured waves of immigrants. They are centers of manufacture and trade. Through museums, symphony halls and similar resources, they foster much of our cultural life. Medical and scientific research and practice have flourished in them. Although we are inclined to think of cities as megalopolises, the term embraces smaller independent communities, which furnish the same services and opportunities to their residents. In a sense, suburban jurisdictions, many of which have their own governments, are simply extensions of city populations. Thus, municipal areas continue to play a vital role in the life of the nation. And to the extent that states contain numbers of local government jurisdictions, the plight of the cities is inextricably related to the welfare of our states.

Local and state governments are facing unparalleled problems. They seem to be running on a treadmill. Rising unemployment is eroding their tax receipts. They are confronted with the need to reduce services—in many instances directly related to the health and security of their citizens—because their residents are unable to bear any additional tax burden. In most states, officials are prohibited from incurring deficits to maintain services because of requirements in their constitutions.

These facts were recognized earlier this year by the Joint Economic Committee in supporting antirecession grants to cities and states.

"Inflation has greatly increased the cost of public services, while recession has seriously eroded the expected growth in revenues and significantly increased expenditures for such recession-related services as public assistance.

"As a consequence, the aggregate state and local government deficit for 1974 was more than $7.5 billion, compared to a $4 billion surplus in 1972, and a balanced position in 1973."

The Committee concluded that financial assistance to these government jurisdictions geared to the rate of unemployment is needed to help solve this serious problem.

Some estimates place the current combined deficits of the state and local jurisdictions at $10 billion.

Earlier this year, the General Board of the AFL-CIO was convened to deal with the severe economic downturn in the nation. Principal officers of the international and national unions affiliated with the AFL-CIO comprise the Board. That meeting occurred in January.

William H. McClennan, President of the Public Employee Department, informed those present:

"This recession is causing unemployment, insecurity and fear among government employees. It is getting worse, not better.

". . . all the news from the public sector suggests that we have a recession deepening into a depression.

"Federal grants to cities have been reduced from a growth rate of $9 billion in 1972 to below $3 billion last year."

At its meeting on February 16, 1975, the Executive Board of the Public Employee Department called for "an emergency transfusion of $6 billion by the federal government to help states and cities maintain their current level of services."

What is needed to resolve the general economic decline our country is experiencing is a total program to produce jobs. In other Congressional forums, the Department has spoken to the need for additional public service jobs, accelerated public works and stimulation to new housing. In short, the PED subscribes fully to the AFL-CIO program for economic recovery.

More to the point at this hearing, however, is the dire need of local governments and states for immediate financial aid. They are in severe economic straits. The Executive Branch budget for fiscal 1976 would aggravate local government fiscal problems by shifting certain joint programs from the federal government to states and cities. Impoundment by the federal government of funds appropriated by Congress for state and local governments will simply deepen the crisis.

The President's intention to impound funds for school assistance in federally affected areas, construction grants for sewers and waste treatment plants, public facility loans, home ownership assistance and many other programs approved by Congress displays a lack of understanding of the financial plight of other government jurisdictions.

As a result of inflation and recession, many municipalities and states are unable to maintain their current level of services. Citizens are confronted with undermanned fire and police protection, uncollected garbage, curtailed education activity, reduced health services, diminished consumer protection and other curtailed public services.

One of the sad results of these curtailments is the effect of employees of the government jurisdictions. The situation is bad enough when thousands of vacancies in public service remain unfilled and payrolls of cities and states are reduced through attrition. But significant numbers of public employees are losing their jobs, working reduced hours, foregoing pay increases provided by negotiated contracts and laws, and using leave because of budgetary limitations.

A small sample of outstanding examples illustrating the serious effect of the economic difficulties faced by municipalities will underscore the extent of the crisis.

In February, 1975, the City of Detroit separated 1,500 employees. Without substantial assistance from the federal government, additional layoffs will be necessary.

During the remainder of this calendar year, 800 workers comprising 10 percent of the municipal work force in Newark, New Jersey, are likely to lose their jobs.

In Atlanta, Georgia, no new employees have been hired since November, 1974. Next month, all workers will be expected to donate one day's work each month without pay.

Attrition has caused the loss of 600 jobs in the City of Cleveland this year. An additional 500 jobs are anticipated to remain unfilled through the attrition process next year. In this municipality, 35 percent of the jobs are financed wholly or partially by federal funds.

The administration in Buffalo, New York, is faced with a $23 million deficit or separation of 1,600 workers, who constitute 25 percent of the work force.

The critical situation in New York City has received nationwide attention recently, and requires no elaboration here.

The outlook for fiscal 1976 is even more dismal, as the Executive Branch budget fails to take account of the 12 percent inflation rate upon federal revenue-sharing funds and grant-in-aid funds. That budget proposed shifting some $1.5 billion of costs of certain joint programs from the federal government to the cities and states.

Fortunately, Congress in recent weeks has addressed itself more realistically to some of these problems. Presidential vetoes of Congressional initiatives to produce more jobs immediately are certainly not the answer. In addition, the basic difficulties faced by cities and states calls for emergency financial assistance to those jurisdictions.

The fact that state and local governments employ more than 12 million persons cannot be ignored as an economic fact of life. Disregarding the effect of a sharp decline in this figure because of unemployment will simply compound the serious problem this nation faces in attempting to reverse the present recession.

Approval of counter cyclical financial aid to these jurisdictions will permit the non-federal governments to maintain their existing level of employment and consequently the essential services they make available to their citizens. It will also allow an immediate inflow of money which will not necessitate an extended period of planning to effectuate because the employees and programs are already in existence. This is not to say that approval of legislation authorizing accelerated public works and additional public service jobs is not desirable. On the contrary, they are necessary ingredients in the general plan to fight recession and inflation. Financial aid to cities and states is needed also because it will complement the other elements of the antirecession plan.

The urgency attached to the serious economic situation confronting our country underscores the need for bold, imaginative steps to immediately solve this problem. There must be recognition of the important function to be played by state and local governments in restoring economic stability to our nation, if they have available the financial assistance they need so badly.

Mr. Chairman, we wish to commend you and your numerous colleagues in the House for introducing bills designed to cope with the crises faced by many local jurisdictions.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

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